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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976.

No. 76-288

GLENN R. HEYMAN, TRUSTEE OF THE ESTATE OF F. W. KOENECKE & SONS, INC., BANKRUPT,

Petitioner,

vs.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,

Claimant, Respondent.

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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KEY TO REFERENCES.

Abbreviations	Explanations
RA	Trustee's Request for Admissions and State's Response Thereto.
FDG	Findings of Fact of Referee Elmer P. Schaefer Entered July 25, 1974.
CONCL.	Conclusions of Law of Referee Elmer P. Schaefer Entered July 25, 1974.
Jones	Transcript of Testimony of Theodore Jones, March 21, 1974.
Hanselman	Transcript of Examination of Catherine Hanselman, November 18, 1969.
Scobbie	Transcript of Examination of John Scobbie, November 19, 1969.

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THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,

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To: The Honorable
Chief Justice and Associate Justices
of the Supreme Court of the United States

Petitioner Glenn R. Heyman, Trustee of the Estate of F. W. Koenecke & Sons, Inc., Bankrupt, respectfully prays that this Court issue a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit, reversing the judgment of the District Court which had disallowed in its entirety the tax claim of the State of Illinois in the sum of $1,268,334.60.

OPINIONS BELOW

Appended to this Petition are the following opinions rendered by the Court below. Only the opinion of the Court of Appeals has been reported. It appears at 533 F. 2d 1020.

1. Opinion of Honorable Elmer P. Schaefer, Referee in Bankruptcy sitting as a Bankruptcy Judge, disallowing in its entirety the tax claim of the State of Illinois in the sum of $1,268,334.60, together with findings of fact, and conclusions of law appended thereto. (A1-A32.)

2. Opinion of Honorable Hubert L. Will, District Judge, affirming order of the Referee disallowing the claim. (A33-A41.)

3. Opinion of the United States Court of Appeals for the Seventh Circuit reversing the District Court and remanding the cause for further proceedings. (A42-A50.)

4. Order of Court of Appeals denying rehearing. (A51.)

GROUNDS OF JURISDICTION

1. The judgment sought to be reviewed was entered by the Court of Appeals on April 20, 1976.

2. Petition for rehearing was timely filed on May 3, 1976, and was denied on June 2, 1976.

3. Jurisdiction to review the judgment of the Court of Appeals is conferred on this Court by Section 24c of the Bankruptcy Act (11 U. S. C. § 47c) and Section 2101c of the Judicial Code (28 U. S. C. §§ 2101(c)).

QUESTIONS PRESENTED

1. Does the "Equal Protection" clause of the United States Constitution permit an Illinois State tax claim to be retroactively imposed against the estate of a bankrupt taxpayer, when the State itself has ruled on identical facts, that it has been estopped by the conduct of its own officials from imposing that retroactive tax claim against all other taxpayers in the state?

2. Is the inherent power of bankruptcy courts to disallow or subordinate inequitable and unconscionable claims, as announced by this Court in *Pepper* v. *Litton*, 308 U. S. 295, 304-5; 84 L. Ed. 281, 60 S. Ct. 238 (1939) to be restricted or curtailed when the claimant guilty of the inequity, happens to be a state revenue department?

3. Do not both general, federal equitable principles and the specific case law of the State of Illinois estop a state revenue department from retroactively assessing a claim against a citizen in the extraordinary situation where there have been positive acts by state officials and detrimental reliance by the taxpayer and its creditors which make it unconscionable and inequitable to permit the State to reverse its previous policy?

4. May a state claim for refund of discounts be granted priority as a tax claim in bankruptcy proceedings when the highest court of the state has specifically held that it is not a tax?

CONSTITUTIONAL AND STATUTORY PROVISIONS WHICH THE CASE INVOLVES

This case involves the following constitutional and statutory provisions, all of which are set forth verbatim in the appendix:

1. U. S. Constitution Amendment XIV, Section 1. (A52.)
2. Bankruptcy Act Sections 2a(2A), 17a, 60, 64a(4), 67d, 70c, e (11 U. S. C. §§ 11a(2A), 35a, 96, 104a(4), 107d, 110c, e). (A52-A66.)
3. Illinois Constitution 1870. Article IX, Section 1. (A66-A67.)
4. Illinois Revised Statutes Chapter 120, Paragraph 453.9a (Cigarette Tax Act, Section 9a); Paragraph 453.43a (Cigarette Use Tax Act, Section 13a). (A67-A72.)

STATEMENT OF THE CASE

This case involves a priority claim made by the State of Illinois against the bankrupt estate for $1,268,334.60. The claim was based on a retroactive assessment made by Illinois in 1968 against all Illinois cigarette distributors who, under a practice previously considered legal (Jones 41, 45),* had obtained maximum discounts through a program of multiple licensing.[1] The evidence established and the trial court found (FDGS 15, 54, 55, A8, A15) that during the period in question, all Illinois officials having responsibility or authority for administering the Cigarette Tax Acts accepted and acknowledged the principle, in accordance with an opinion rendered by the State's Attorney General, that the use of such multiple licenses in order to maximize discounts was perfectly legal and proper, even though it was obvious to all concerned that the multiple licensees were mere figureheads and not true, independent business entities. (FDG 15, A8.) The evidence further established and the trial court found that during the period in question Illinois officials actively participated in every phase of the multiple licensing procedure. (FDGS 15-17, 20-46, A7-A14.) The benefits of the discounts thus obtained were in the large part passed on to the customers in the form of reduced prices. (FDG 85, A21.)

Illinois, through its own quasi-judicial machinery found and determined that, by virtue of its own active participation in the multiple license procedure, it was equitably estopped—with respect to every distributor other than the bankrupt, F. W.

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* A key to all references is found opposite page 1 of this petition.

1. The state law, as amended in 1963 provided that the distributor's discount which formerly had been a flat percentage of tax stamps purchased, was thereafter to be computed on an "inverse" graduated formula. By splitting their purchases among multiple licensees, all Illinois distributors having more than the prescribed volume of $700,000 per annum were able to continue to receive the maximum discount.

Koenecke & Sons, Inc. (Koenecke)[2]—from retroactively enforcing any portion of the deficiency claimed. The Official Hearing Reports—adopted as the opinion of the State Director of Revenue, concluded in twenty-three of the twenty-four cases that:

> "The Department, acting in the governmental role of tax collector, has by its conduct 'comforted' each licensee into assuming that the discounts were allowable. The Department knew that the multiple licenses were set up for the sole purpose of earning maximum discounts and in fact, cooperated actively with the licensees in determining the most advantageous point at which to begin purchasing on another license. These circumstances affected the pricing policy of the licensees. To assess and collect the sought after tax would cause the licensees to absorb the tax which was never intended by the Illinois Cigarette Tax Act. Such tax collection policies, being unjust and inequitable, should not be allowed."

and in the remaining case that:

> It is the opinion of the undersigned that the Department's passive and active conduct in knowingly permitting and encouraging multiple licensing, and the Attorney General's written opinion, create an estoppel against the State in its attempt to successfully realize the amount claimed herein.

At the same time that Illinois rendered these opinions in the case of all the other distributors, it filed, and continued to press its claim against Koenecke in the Bankruptcy Court. Objections were filed by the Trustee, joined by the principal general creditors, whose claims aggregated almost $2,500,000.

The Referee in Bankruptcy sitting as a Bankruptcy Judge, conducted extensive hearings in the Bankruptcy Court on the State claim and the Trustee's objections. On July 25, 1974

2. Upon the initiation of the bankruptcy proceeding, exclusive jurisdiction to determine the claim against Koenecke passed to the Bankruptcy Court pursuant to Section 2(a)(2A) of the Bankruptcy Act (11 U. S. C. § 11(a)(2A)(A52).

he entered an order disallowing the claim in its entirety. The principal grounds for disallowance were:

> 1. The State was estopped by its own active participation in the multiple license procedure from retroactively assessing the excess discount against the Koenecke estate. (CONCL. No. 5, (A22-A23);
>
> 2. The attempt by the State to impose retroactive liability against Koenecke, after disallowing all claims of similar liability against all other Illinois distributors constituted intentional and purposeful discrimination against the Koenecke estate. (CONCL. No. 14, A24);
>
> 3. Even if the claim were valid under State law, it would be unconscionable and inequitable and contrary to the equitable principles which control bankruptcy proceedings to permit any portion of the claim to participate on a parity with, or prior to, the claims of general unsecured creditors. (CONCL. No. 16, A24.)

The District Judge, on appeal, affirmed. The Court of Appeals, however, reversed and remanded and denied rehearing This petition followed.

BASIS FOR FEDERAL JURISDICTION

The basis for federal jurisdiction is Section 2 of the Bankruptcy Act (11 U. S. C. § 11) and particularly sub-section a (2A) thereof (11 U. S. C. § 11a(2A). (A52).

ARGUMENT

I.

THE COURT OF APPEALS HAS DECIDED IMPORTANT QUESTIONS OF FEDERAL LAW IN A MANNER WHICH CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT AND OF OTHER COURTS OF APPEALS

A. The Equitable Subordination Question.

In the classic landmark case of *Pepper* v. *Litton*, 308 U. S. 295, 304-5, 84 L. Ed. 281, 60 S. Ct. 238 (1939) this court declared in the most sweeping terms, the inherent power of a court of bankruptcy to subordinate or disallow any claim against a bankrupt estate where it would be unconscionable and inequitable to permit it to participate on a parity with—much less prior to—the claims of general unsecured creditors. At pages 307-308, this Court said:

> "In the exercise of its equitable jurisdiction, the *bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.*" (Emphasis added.)

The doctrine of equitable subordination is independent of, and frequently overrides state law. In *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89, 62 S. Ct. 978, 86 L. Ed. 1293 (1942) this Court said at page 95:

> "The bankruptcy act prescribes its own criteria for distribution to creditors. In the interpretation and application of federal statutes, federal not local law applies. (citing cases.) The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, (citing cases) and it is for *that court* —not without appropriate regard for rights acquired under rules of state law—*to define and apply federal law in*

> *determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class.*" (Emphasis added.)

It is difficult to conceive of a case which calls out more strongly than this one for equitable disallowance or subordination. Here we have as a claimant, the State of Illinois, which admittedly was part and parcel of the entire multiple license scheme from start to finish, and which itself has ruled that as to all other cigarette distributors in Illinois, its own active participation in multiple licensing has estopped it from making any retroactive assessment.

Opposing the State claim on the other hand, is the Trustee in Bankruptcy, representing general unsecured creditors who had no part whatsoever in the multiple license scheme and who in no way, profited or benefited from the increased discounts. The Referee was more than justified in concluding as he did, that it would be inequitable and unconscionable to permit the claim to participate even on a parity with the just claims of general unsecured creditors.

Significantly, the Court of Appeals does not dispute the State's active participation in the license scheme. At page 3 of its opinion (A44, 533 F. 2d 1022) the Court notes:

> ". . . officials of the Illinois Department of Revenue having responsibility for administering the cigarette tax acts granted secondary or multiple licenses to persons closely related to Koenecke even though it was obvious that such secondary licensees were mere figureheads and were to be utilized solely for the purpose of avoiding the effect of the graduated discount law.
>
> In fact employees of the state affirmatively participated in Koenecke's attempt to minimize taxes. The evidence shows that one of the Department of Revenue's auditors actually taught Koenecke personnel how to compute and report the nominal intercompany transfers to and from secondary licensees which were shown on the monthly returns. It was admitted that from time to time Department

personnel called Koenecke and other distributors to remind them that it was time to change licenses in order to avoid going over the $700,000 limit." (Footnote omitted.)

Further, the Court of Appeals conceded the inherent power of a Bankruptcy Court to subordinate inequitable claims. (A49.) Nevertheless, it reversed the Referee and the District Judge, saying (A49, 533 F. 2d 1024-5):

> "But in this instance we think the bankruptcy judge's conclusion of law No. 16 was wrong in holding that it would be inequitable for the State to participate on a priority or even equal basis with the other creditors. We believe that the proper view of the facts does not show that the state is profiting at the expense of the creditors. Rather all the people of the State are benefited when taxes which are lawfully owing are collected. Therefore we are of the opinion that the bankruptcy judge should not have subordinated the State's claims of general creditors unless the general creditors can establish some type of priority for their claims under the bankruptcy act."

By conditioning equitable subordination upon specific statutory priority, the Court of Appeals has, in effect, reduced *Pepper* v. *Litton* and *Prudence* v. *Geist* to a nullity. If, the general creditors could establish a *statutory* priority for their claims, equitable subordination would be neither necessary nor appropriate. Equitable subordination, by its very nature, is called into play only in those cases where there is no specific *statutory* basis therefor, but where it is nevertheless compelled by the particular equities of the particular case.

Moreover, the Court of Appeals would seem, contrary to the mandate of *Prudence* v. *Geist*, to have permitted state law (as it construed it) to dilute the equitable principles which control the administration of bankrupt estates. It is apparent that the court below considered itself bound by what it considered to be controlling Illinois law on the issue of equitable estoppel. In this, we submit, the court below was in clear conflict with both *Pepper* v. *Litton* and *Prudence* v. *Geist*, which compel the

reference to be solely to basic principles of federal bankruptcy law.

The Court of Appeals has apparently concluded that regardless of the equities involved, subordination may not be imposed by a Bankruptcy Court against a state revenue claim. It is true that neither in *Pepper* v. *Litton* nor in any other case known to petitioner, has this Court specifically applied equitable subordination to a state revenue claim. However, the federal courts have consistently applied to taxing bodies in non-bankruptcy situations, equitable doctrines closely analogous to those which the Bankruptcy Judge and the District Judge found to be applicable here.

In *United States* v. *Kaiser*, 363 U. S. 299, 308, 80 S. Ct. 1204, 4 L. Ed. 2d 1233 (1960), Mr. Justice Frankfurter, concurring, succinctly declared in language directly applicable to this case, that:

> "The Commissioner cannot tax one and not tax another without some rational basis for the difference."

The *Kaiser* doctrine has been followed in at least three cases strikingly similar to our own. In *Farmers' and Merchants' Bank* v. *United States*, 476 F. 2d 406, 408-409 (4 Cir. 1973); *International Business Machines Corp.* v. *United States*, 343 F. 2d 914, 923 (Ct. Cl. 1965) *cert. den.* 382 U. S. 1028; and *Exchange Parts Company of Fort Worth* v. *United States*, 279 F. 2d 251, 254 (Ct. Cl. 1960) the Court specifically held the Government to be estopped from applying a new tax interpretation retroactively as to certain taxpayers while applying it only prospectively as to others.

Similarly, the Federal Courts have estopped the government from retroactively reversing a tax ruling or interpretation where there has been justified detrimental reliance on the earlier interpretation. *LeSavoy Foundation* v. *Commissioner*, 238 F. 2d 589, 591-592 (3 Cir. 1956); *Stockstrom* v. *Commissioner*, 190 F. 2d 283 (D. C. 1951); *H. S. D. Co.* v. *Kavanagh*,

191 F. 2d 831 (6 Cir. 1951); *Woodworth* v. *Kales*, 26 F. 2d 178 (6 Cir. 1928).

In our case, the Bankruptcy Court, on behalf of innocent, good faith creditors, applied to the claim of the State of Illinois, the same equitable considerations which the federal courts have invoked in appropriate circumstances as against the United States itself. That action by the Bankruptcy Court, as affirmed by the District Judge, was clearly mandated by decisions of this Court in *Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939); *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89, 62 S. Ct. 978, 86 L. Ed. 1823 (1942). The reversal by the Court of Appeals was clearly inconsistent with the applicable decisions of this Court and should be reviewed on certiorari.

The degree of conflict between the decision below and the controlling decisions of this court becomes even more apparent when it is recalled that equitable subordination is only one key element in the entire complex of applicable legal principles which have been designed and structured to achieve the ultimate objective of bankruptcy administration—preservation of the paramount rights of bona fide general unsecured creditors. Fundamental to the entire philosophy of American Bankruptcy Law is the overriding concept that the trustee, as representative of creditors, is vested with an extensive array of powers and defenses which would never have been available to the bankrupt itself. These include, in addition to the power of equitable subordination, the right to avoid preferential transfers, which in the absence of bankruptcy, would be perfectly legitimate payments of just debts (Bankruptcy Act § 60 (A54-A61); the right to avoid as against third parties, transfers tainted with constructive or actual fraud in which the bankrupt may well have been a willing participant (Bankruptcy Act §§ 67d, 70e (A62-A66); and all rights and powers, which could be exercised by judgment, execution, and/or judicial lien creditors, regardless of whether such creditors exist (Bankruptcy Act § 70c. (A65.)

The Court of Appeals, not only rejected the concept of equitable subordination, but in addition, completely disregarded the distinction carefully enunciated both by Congress and by the Courts, between the paramount rights and equities of bona fide creditors and those which might be asserted by the bankrupt itself. Thus, at one point (A49, 533 F. 2d 1024), the Court remarks that:

> "Certainly the equities were even more on the side of the *taxpayer* in *Chicago Thoroughbred Enterprises* than in the present case." (Emphasis added.)

and, subsequently goes on to express the astonishing conclusion that (A50, 533 F. 2d 1025):

> "The creditors of Koenecke, of course, are not being penalized or prosecuted in any way. Their complaints are against Koenecke not the State. Their right to enjoy the illegal fruit of the Koenecke scheme by usurping the unpaid state taxes resulting from the multiple license plan can be no greater than the taxpayer's right to avoid those taxes."

By equating the rights of creditors with those of the bankrupt[3] the Court of Appeals substantially undermined the special status which both Congress and the federal courts have carefully and consistently conferred upon the trustee as representative of *creditors* of a bankrupt estate. If permitted to stand, the opinion below could well presage a sharp retreat from that fundamental philosophy which has heretofore characterized the administration of bankrupt estates by courts of the United States.

B. The Equal Protection Question.

This court has consistently held that the "Equal Protection" clause found in Amendment XIV, Section 1 of the U. S. Constitution prohibits a State from enforcing any state law against one citizen in a manner different from that in which the same law is applied to others under similar circumstances and condi-

3. At one point, in a reference which was obviously inadvertent, but nevertheless revealing, the Court actually described this trustee as the "appellee Koenecke." (A48, 533 F. 2d 1024.)

tions. *Duncan* v. *Missouri*, 152 U. S. 377, 38 L. Ed. 485, 14 S. Ct. 570 (1894); *Tinsley* v. *Anderson*, 171 U. S. 101, 43 L. Ed. 91, 18 S. Ct. 805 (1898); *Field* v. *Barber Asphalt Paving Co.*, 194 U. S. 618, 48 L. Ed. 1142, 24 S. Ct. 784 (1904); *Southern Railway Co.* v. *Greene*, 216 U. S. 400, 54 L. Ed. 536, 30 S. Ct. 287 (1910); *Williams* v. *Arkansas*, 217 U. S. 79, 54 L. Ed. 673, 30 S. Ct. 493 (1910); *Louisiana ex rel. Francis* v. *Resweber*, 329 U. S. 459, 91 L. Ed. 422, 67 S. Ct. 374 (1947). Specifically, in the field of taxation, it has been held that tax laws must be similarly applied against taxpayers similarly situated. *United States* v. *Kaiser*, 363 U. S. 299, 308, 80 S. Ct. 1204, 4 L. Ed. 2d 1233 (1960) (Mr. Justice Frankfurter, concurring); *Farmers' and Merchants' Bank* v. *United States*, 476 F. 2d 406, 408-9 (4 Cir. 1973); *International Business Machines Corp.* v. *United States*, 343 F. 2d 914, 923 (Ct. Cl. 1965) *cert. den.* 382 U. S. 1028; *Exchange Parts Company of Fort Worth* v. *United States*, 279 F. 2d 251, 254 (Ct. Cl. 1960). The decision of the Court of Appeals, however, expressly sanctions the action of the State of Illinois in applying to the bankrupt estate, a rule of law directly contrary to that which the State itself applied to every other similarly situated Illinois tobacco distributor.

The record established and the referee found that the purpose, manner and technique of use of secondary or multiple licenses by the other Illinois distributors was identical to the purpose, manner and technique of the use of such multiple licenses by Koenecke. (FDG 26, A10.) The only grounds of distinction urged by the State were (A45-A46, 533 F. 2d 1022) that Koenecke was guilty of fraudulent conduct, and that the amounts involved in Koenecke's case were much larger than in the others. The Court of Appeals expressly found (A50, 533 F. 2d 1025) that the charges against Koenecke of fraud and corruption were not supported by the record, thus leaving only the difference in dollar amounts. Nevertheless the Court of Appeals found no violation of the Equal Protection clause, saying (A46, 533 F. 2d 1022-3):

> "The State Department of Revenue's decision not to make assessments of the other distributors does not rise to the level of a controlling administrative determination of state law, especially in view of the Illinois Supreme Court cases discussed below. It amounted only to an election by the state to proceed only against Koenecke. That election did not violate Koenecke's federal equal protection rights, because the trustee has not shown that it was deliberately based upon an unjustifiable standard such as race, religion or other arbitrary classification."

With due respect, we submit that the Court of Appeals has completely misconstrued the action of the State of Illinois. The State's decisions with respect to the other distributors were far more than mere "elections." On the contrary, they were in fact and in law final determinations of issues of state law based on facts which both the referee (A3) and the District Judge (A39) found to be "virtually identical" to our case.

The State initially made a blanket determination that the retroactive discount was due from all Illinois distributors including Koenecke. (RA. Ex. G.) The evidence was undisputed that the bases and criteria for the retroactive assessments against the other distributors were identical to the bases and criteria for the retroactive assessment against Koenecke. (FDG 63, A17, Jones 32-33, 40; Hanselman 75-77; Scobbie 56-57.) It then formally issued notices of tax liability against each of these distributors. Protests were filed, and formal hearings were conducted.[4] At the conclusion of the hearings the State Director of Revenue,—an official of cabinet rank—approved the reports of his hearing officers who had found and determined that with respect to every distributor other than Koenecke, the State's "active conduct in knowingly permitting and encouraging multiple licensing" had estopped it from retroactively collecting any

4. Except in the case of Koenecke which was already in bankruptcy (see footnote 2, p. 6) and except for the cases of those Downstate Distributors where the Department held that since the facts were identical to those already heard, no further evidence was necessary. (FDGS 75-78, A19-20.)

of the discounts in question. The Illinois Cigarette Tax Acts (A67-A72) specifically provide that such decisions after hearing and notice shall be a final determination of the legality and amount of tax due, subject only to the available right of judicial review—which, for obvious reasons was never exercised. This judicial determination that the state was legally and equitably estopped from enforcing the alleged tax liability was far more than a mere "election not to proceed." Rather the State applied and invoked in favor of all other distributors, a Rule of Law which is irreconcilably opposed to the Rule of Law which the State urged and Court of Appeals applied, against the bona fide general, unsecured creditors of the Koenecke estate.

Nor can it be said that the State's discrimination against the Koenecke estate was anything but arbitrary. As pointed out above, the only true distinction between Koenecke's case and all the others is in the dollar amounts involved. Furthermore the evidence established that the principal purpose of the graduated discount law was to put Koenecke out of business. (See Testimony of Sen. Hudson Sours, R. A. Ex. H-8(b) pp. 5-7). A more flagrant example of "arbitrary discrimination" is difficult to imagine.

The extent to which the Court of Appeals misunderstood the applicable principles of equal protection is graphically illustrated by its reliance (A46, 533 F. 2d 1023) on this Court's decision in *Oyler* v. *Boles*, 368 U. S. 448, 456, 82 S. Ct. 501, 506, 7 L. Ed. 2d 446, 453 (1962). In the *Oyler* case this Court held that a state did not violate the Equal Protection clause by enforcing its habitual criminal statute against some but not all habitual offenders because there was no showing of a deliberate policy of discrimination. Our case, however, presents the precise type of deliberate, arbitrary discrimination found lacking in *Oyler* v. *Boles*. The *Oyler* case thus, to the extent applicable at all, actually contradicts, rather than supports, the decision of the Court of Appeals.

The ultimate irony of the Court of Appeals' decision is that, unless reversed by this Court, the only persons who will have borne the effects of any of the retroactive assessments attempted by the State of Illinois will be the bona fide unsecured creditors of this estate, none of whom played any part in, or benefited in any way from, the multiple licensing program.

II.

ALTERNATIVELY, THIS CASE PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, DECIDED BY THIS COURT

We have urged in Section I hereinabove (pp. 8-17), that the decisions of this Court in *Pepper* v. *Litton*, 308 U. S. 295, 304-5, 84 L. Ed. 281; 60 S. Ct. 238 (1939) and *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89, 95; 62 S. Ct. 978; 86 L. Ed. 1293 (1942) authorize and mandate the subordination or disallowance of all inequitable claims, including those of State taxing bodies. If, however, this Court should be of the opinion that it is still an open question whether State tax claims can be so subordinated or disallowed, we submit that this question is of extreme importance in the administration of bankrupt estates and warrants consideration by this Court on certiorari.

The Court of Appeals reversed the referee's subordination of the State claim because in its opinion ". . . all the people of the State are benefited when taxes which are lawfully owing are collected." (A49, 533 F. 2d 1024.) The Court of Appeals thus concluded that the benefit of enhancing revenues overrides all of the usual considerations of equitable distribution, which this Court has mandated for bankruptcy cases. The rationale of the Court of Appeals, if carried to its logical conclusion, would condone every conceivable arbitrary and capricious act by the state or federal officials so long as the end result was to increase revenues.

This Court should accept the opportunity to adopt and announce a rule of law which will protect the legitimate interests

of bona fide creditors or bankrupt estates, and also of citizens generally, against arbitrary and discriminatory enforcement of state revenue statutes.

III.

THE COURT OF APPEALS HAS DECIDED IMPORTANT QUESTIONS OF ILLINOIS LAW WHICH ARE IN CONFLICT WITH APPLICABLE ILLINOIS LAW AS ANNOUNCED BY THE SUPREME COURT OF ILLINOIS

A. Equitable Estoppel

Basic and fundamental to the opinion of the Court of Appeals, is its conclusion that Illinois law absolutely prohibits the application of equitable estoppel to a State revenue claim. The Illinois cases do *not* so hold, but rather, they *limit estoppel* to cases like ours, where the State has *actively* and *affirmatively* induced reliance by an adverse party. The applicable rule, was announced in *City of Quincy* v. *Sturhahn*, 18 Ill. 2d 604, 614; 165 N. E. 2d 271, 277, 81 A. L. R. 2d 1425 (1960), and reiterated in *Hickey* v. *Illinois Central Railroad Co.*, 35 Ill. 2d 427; 220 N. E. 2d 415, 426-427 (1966), is as follows:

> "While situations may arise which justify invoking the doctrine of estoppel even against the State when acting in its governmental capacity [citing cases], we have always adhered to the rule that mere nonaction of governmental officers is not sufficient to work an estoppel and that before the doctrine can be invoked against the State or a municipality *there must have been some positive acts by the officials which may have induced the action of the adverse party under circumstances where it would be inequitable to permit the corporation to stultify itself by retracting what its officers had previously done. . . .*" (Emphasis Added.)

To the same effect, see *People* v. *Thomas*, 361 Ill. 448, 456 (1935); *Trustees* v. *Village of Cahokia*, 357 Ill. 538, 543 (1934); *Melin* v. *Community Consolidated School District*, 312

Ill. 376, 383 (1924); *State of Illinois* v. *Illinois Central Railroad Co.*, 246 Ill. 188, 235 (1910).

Furthermore, even in those Illinois cases relied on by the Court of Appeals, the Illinois Supreme Court, while denying estoppel on the facts then before it, nevertheless specifically noted that in extraordinary cases such as ours, where there have been positive, affirmative acts by State officials which induced an adverse party to alter his position, the doctrine of estoppel can and should be applied. In *People ex rel. Scott* v. *Chicago Thoroughbred Enterprises, Inc.*, 56 Ill. 2d 210, 306 N. E. 2d 7 (1973) the Illinois Supreme Court specifically acknowledged (56 Ill. 2d 220, 306 N. E. 2d 12) that

> ". . . the doctrine of estoppel cannot be invoked where governmental authorities of the State are concerned, particularly those relating to public revenues, *except in extraordinary circumstances.*" (Emphasis added.)

In that case, unlike ours, the court held that estoppel was inapplicable because the only positive acts committed by State employees were "ministerial" in nature, 306 N. E. 2d at p. 13.

Similarly in *Austin Liquor Mart* v. *Department of Revenue*, 51 Ill. 2d 1, 280 N. E. 2d 437 (1972), also relied upon by the Court of Appeals, the Illinois Supreme Court specifically noted at page 440:

> *"While it is true that the State has no absolute immunity from the application of equitable principles,* our opinion in Hickey reaffirms the general rule that the State cannot be estopped in the exercise of its power of taxation or the collection of revenue *unless necessary to prevent fraud and injustice.*" (Emphasis added.)

And, in *Mr. Car Wash, Inc.* v. *Department of Revenue*, 27 Ill. App. 3d 931, 327 N. E. 2d 88 (1975), also relied upon by the Court of Appeals, the Illinois Supreme Court noted at 327 N. E. 2d 91:

> "We do not find the 'extraordinary circumstances' present in *Hickey* v. *Illinois Central R. R. Co.*, 35 Ill. 2d 427, 220 N. E. 2d 415, to be present here so that the State

is precluded by basic concepts of right and justice from claiming tax liabilities lawfully due."

In our case, however, there were a whole series of positive, affirmative acts on the part of State officials which could, in no sense be called ministerial, and which had no counterpart in the cases relied on by the Court of Appeals, namely:

1. The Attorney General rendered an opinion which the Court of Appeals conceded to have been nebulous, and which was consistently "interpreted and construed by the Department as authorizing and mandating the grant of recording licenses to mere figureheads for the sole purpose of maximizing discount." (Fdgs. 15, 53, 54, 55, A8, 15.)

2. The identical practices followed by Koenecke were followed by every other Volume Distributor in the State of Illinois. (Fdgs. 19, 21, 22-26, A9, 10.)

3. The Illinois State Auditor assigned to the Koenecke operation affirmatively assisted in preparation of the multiple license returns. (Fdg. 41, A13.)

4. Department officials frequently called Koenecke and other distributors to advise them to change licenses in order to avoid the $700,000 limit. (Fdg. 46, A14.)

5. The top legal advisors of the Department of Revenue formally advised the Director in 1968, that under the existing interpretation of the Attorney General's opinion the use of secondary licenses as then practiced by Koenecke and every other Volume Distributor was perfectly legal. (Jones 41, 45.)

6. The Department of Revenue, after full and complete hearings in accordance with the procedure established by law, found and determined that as a matter of law, on grounds which are completely applicable to the Koenecke case, that the State was estopped from collecting the retroactive discount from any of the other Volume Distributors.

It was "patently inequitable" and contrary to basic principles of right and justice to permit the State to "stultify itself" by retracting any or all of these positive acts committed by Illinois officials. The extraordinary circumstances which the Illinois Courts found lacking in *People ex. rel. Scott* v. *Chicago Thoroughbred Enterprises, Inc.*, 56 Ill. 2d 210, 306 N. E. 2d 7 (1973); *Austin Liquor Mart* v. *Department of Revenue*, 51 Ill. 2d 1, 280 N. E. 2d 437 (1972) and *Mr. Car Wash, Inc.* v. *Department of Revenue*, 27 Ill. App. 3d 931, 327 N. E. 2d 88 (1975) are all present here. As District Judge Will so aptly commented (A38)

". . . if there ever was or could be a case where the circumstances were so extraordinary as to justify estoppel against the State, this is the case."

The Court of Appeals' refusal to apply estoppel against the State claim was in sharp conflict with the applicable Supreme Court opinions. Certiorari should be granted to resolve that conflict.

B. The Priority Status of the Claim

At the close of its opinion (A50, 533 F. 2d 1025) the Court of Appeals held that the State's claim is properly a tax claim (and thus, at least in part, entitled to priority under Sections 17a and 64a(4) of the Bankruptcy Act (11 U. S. C. §§ 35a, 104a (4), A52-54, 61). This conclusion is in direct conflict with the decision of the Illinois Supreme Court in *Heyman* v. *Mahin*, 49 Ill. 2d 284, 275 N. E. 2d 421, *cert. den.* 405 U. S. 1075, 31 L. Ed. 2d 809 (1972).

In *Heyman* v. *Mahin* the Illinois Court considered the question whether the Illinois graduated discount law imposed a graduated tax contrary to the uniformity provisions of the then applicable Illinois Constitution of 1870, and Amendment XIV of the U. S. Constitution. In reaching a negative conclusion the Illinois court said at 275 N. E. 2d at 421, 424:

> "The plaintiff therefore was not a taxpayer subsequent to the 1963 amendment to the Act but was instead acting solely as an agent for the State in the collection and the remittance of the tax. Since we have determined that no tax is imposed on the distributors of cigarettes under the provisions of section 2(b) of the Act, the graduated discount provision thereof cannot therefore violate section 1 of article IX of the Illinois Constitution of 1870 (uniformity provision)."

The validity of the law which forms the basis for the State claim is therefore dependent on the explicit holding of the Illinois Supreme Court that the discounts involved here are compensation, not a deduction from taxes. Either the Court of Appeals erred in not following that decision, or, in the alternative, the Illinois Supreme Court was in error in upholding the constitutionality of the underlying law. *Stewart Dry Goods Company* v. *Lewis*, 294 U. S. 550, 555-556, 55 S. Ct. 525, 79 L. Ed. 1054 (1935), *Valentine* v. *Great Atlantic & Pacific Tea Co.*, 299 U. S. 32, 33, 57 S. Ct. 56; 81 L. Ed. 22, 23 (1936). In the latter event, this constitutional defect is, by itself sufficient ground for disallowance of the claim. In either event, review by certiorari is well warranted.

CONCLUSION

WHEREFORE, Petitioner prays that this court issue a writ of certiorari to the Court of Appeals for the Seventh Circuit to review the decision rendered in the within case.

Respectfully submitted,

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APPENDIX.

IN THE UNITED STATES DISTRICT COURT
For the Northern District of Illinois,
Eastern Division.

F. W. KOENECKE & SONS, INC., an Illinois corporation, *Bankrupt.* DEPARTMENT OF REVENUE, STATE OF ILLINOIS, *Claimant,* *vs.* GLENN R. HEYMAN, *Trustee.*	In Bankruptcy No. 69 B 1647

OPINION.

This cause came on for hearing on the objections of Glenn R. Heyman, trustee, to Claim No. 6 filed by the Department of Revenue, State of Illinois, as a tax claim in the amount of $1,268,334.60 and the answer filed by the Department of Revenue to the trustee's objections.

At the conclusion of the hearing, the Court requested both sides to submit memoranda of law and suggested findings of fact and conclusions of law. The Court has carefully reviewed the evidence and the memoranda as well as the authorities cited by both sides. The Court has adopted as its findings, conclusions and order submitted by the attorneys for the trustee, which findings, conclusions, and order are appended to and made part of this opinion. The facts of the case, which are

largely undisputed, are set forth in detail in the appended findings, may be summarized as follows:

The bankrupt "Koenecke" was the largest cigarette distributor in the State. As a distributor it was required by Illinois law to collect and remit the tax imposed on the sale and use of cigarettes (Ill. Rev. St. Ch. 120, paras. 453.1-453.67). For its services in purchasing and affixing the stamps, Koenecke like all other distributors, was entitled to receive a discount, which up until 1963 was a flat 5% of all stamps purchased. Beginning in 1963, the Illinois legislature adopted a graduated discount which had the effect of sharply increasing the tax burden imposed on Koenecke and all other large distributors, thus placing them at a severe competitive disadvantage with smaller distributors.

Although adopted in 1963, the graduated discount was never enforced until five years later in 1968. The reason was that immediately after the new law went into effect, the State actively and affirmatively participated with Koenecke and all other volume distributors in a "multiple licensing" procedure whereby they divided their purchases over a sufficient number of licenses so that all qualified for the maximum discount.

Five years later, in August, 1968, the Department reversed its policy and cancelled all multiple licenses. At the same time it attempted retroactively to assess against all volume distributors, including Koenecke, the amount of discounts which they had saved through the use of multiple licenses during the preceding three year period* when multiple licensing was not only approved, but actively participated in, by the State.

As to all of the other distributors, the State itself ultimately ruled that by virtue of its own active participation in the multiple-license procedure, it was estopped and precluded from making any retroactive assessment of cigarette tax. As to

* Illinois law apparently imposes a three-year limitation on all cigarette tax assessments.

Koenecke, however, the State nevertheless insists that, on facts which the Court finds to be identical in every material respect, it is entitled to collect the retroactive assessment in full as a priority claim in advance of any distribution to unsecured creditors. In the opinion of this Court, neither applicable State law, nor the equitable principles of Bankruptcy Administration would condone such an inequitable result.

In addition to the reasons for disallowance set forth in the appended findings and conclusions, the Court makes the following observations:

1. Reference has been made by the State to an opinion rendered by the Supreme Court of Illinois upholding the constitutionality of the graduated discount law (*Heyman* v. *Mahin*, 49 Ill. 2d 284, 275 N. E. 2d 421). This opinion has no bearing in this case for at least two reasons. First, the case before the Supreme Court involved only the prospective application of the law during the period *after* August, 1968, it had nothing to do with the attempted retroactive, discriminatory assessment which is involved here. Also, it is not insignificant that the reported opinion was preceded by an unreported opinion ("Exhibit A") in which the Illinois Court held that this tax might well be unconstitutional if its effect were shown to be, in fact, discriminatory. In the subsequent reported opinion, the Illinois Court did not specifically overrule the earlier opinion.

2. The State vigorously asserts that being a sovereign body, it cannot be charged with estoppel. This argument simply is not supported by law. First of all, Illinois Courts have consistently held that estoppel can, and should, be imposed against the State whenever it has actively participated in the conduct which gave rise to the estoppel. The State itself specifically found in the case of all other distributors, and this Court specifically finds in the case of Koenecke, that the State did actively participate from beginning to end in the multiple licensing procedure and must therefore, be estopped from imposing a tax based

upon the attempted retroactive revocation of those same multiple licenses. The doctrine of estoppel is therefore completely appropriate here. *New Mark Builders* v. *City of Aurora,* 1968, 90 Ill. App. 2d 98, 233 N. E. 2d 44, 46-47; *Hickey* v. *Illinois Central Railroad Co.,* 1966, 35 Ill. 2d 427, 220 N. E. 2d 415, 426; *City of Quincy* v. *Sturhaan,* 1960, 18 Ill. 2d 604, 165 N. E. 2d 271, 277; *Pressed Steel Car Co.* v. *Lyons,* 1955, 7 Ill. 2d 95, 129 N. E. 2d 765, 771, and in the findings of fact and conclusions of law attached hereto and made part hereof.

Moreover, it must be recalled that in determining the distribution of the assets of a bankrupt estate, the controlling equitable principles are a matter of overriding federal bankruptcy law. In a case such as this where it would be patently inequitable and unconscionable to allow the claim prior to, or on a parity with, the claims of other creditors the bankruptcy Court can and must disallow it on equitable ground even if it might be legally valid as against the debtor under State law. *Pepper* v. *Litton,* 368 U. S. 295, 304-5, 308, 84 L. Ed. 281, 60 S. Ct. 238, *Collier* on Bankruptcy, 14th Ed., Vol. 3, Para. 57.14, pp. 211-212.

Finally, to allow this claim as against the Koenecke estate, after the State itself has disallowed the corresponding claims against all other distributors, would be precisely the type of intentional and purposeful discrimination which the Court of Appeals for this Circuit recently denounced in *Weisberg* v. *Powell,* 7 Cir. 1969, 417 F. 2d 388, 392.

Accordingly, Claim No. 6 of the State of Illinois in the sum of $1,268,334.60 has been disallowed in its entirety as per the appended formal findings of fact, conclusions of law, and order which have been simultaneously and as a part hereof been entered by this Court.

/s/ ELMER P. SCHAEFER,
Bankruptcy Judge.

Dated July 25, 1974.

IN THE UNITED STATES DISTRICT COURT
For the Northern District of Illinois,
Eastern Division.

In re F. W. KOENECKE & SONS, INC., an Illinois corporation, *Bankrupt.* DEPARTMENT OF REVENUE, STATE OF ILLINOIS, *Claimant,* *vs.* GLENN R. HEYMAN, *Trustee.*	In Bankruptcy No. 69 B 1647

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER.

The Trustee, Glenn R. Heyman, has objected to the allowance of Claim No. 6 filed by the Department of Revenue of the State of Illinois as a tax claim in the sum of $1,268,-334.60. The Answer filed by the Department to the Trustee's objection states that the claim is based as an assessment allegedly made as a result of uncovering certain allegedly fraudulent practices perpetrated by the bankrupt corporation and 54 other so-called affiliated licensees whereby certain discounts were claimed and received to which said corporation would not otherwise have been entitled.

The Court has received evidence and heard testimony. Most of the material facts have been stipulated and admitted of record. The following findings of fact and conclusions of law are drawn from these admissions, stipulations, evidence and testimony and are supported by parenthetical reference to

specific portions of the record. Exhibit A appended hereto is a key to the abbreviations used for the purpose of such references to the record.

FINDINGS OF FACT.

1. F. W. Koenecke & Sons, Inc. ("Koenecke"), was, prior to bankruptcy, the largest cigarette distributor in the State of Illinois. (RA 1)

2. Koenecke was licensed as a cigarette distributor under the Cigarette Tax Act and the Cigarette Use Tax Act of Illinois (Ill. Rev. St., Ch. 120, paragraphs 453.1-453.67) ("The Cigarette Tax Acts"). (RA 2)

3. Under the Cigarette Tax Acts, Koenecke, as a licensed distributor, was, at all pertinent times, required to purchase and affix to each package of cigarettes sold in Illinois, stamps evidencing payment of Illinois tax. (RA 3)

4. From their inception the Cigarette Tax Acts have granted to licensed distributors a discount on the purchase of tax stamps. (RA 4)

5. Until August, 1963, the discount was a flat 5% on all stamps purchased, regardless of volume. (RA 5)

6. In August, 1963, the Cigarette Tax Acts were amended to provide for a graduated percentage discount, decreasing sharply with increasing volume. These amendments are hereinafter referred to as the "Graduated Discount Law." (RA 6)

7. Since 1963, the maximum percentage discount has been granted on the first $700,000.00 of stamps purchased in any one fiscal year (July 1 to June 30). With each increasing increment of $700,000.00 the discount declines, reaching a minimum after the purchase of $2,100,000.00 in a fiscal year (RA 7)

8. Prior to bankruptcy, Koenecke's volume of business brought it to the minimum discount bracket of $2,100,000.00 within the first three weeks of each fiscal year. (RA 8)

9. Shortly after the effective date of the "graduated discount law," in August, 1963, Robert Koenecke (Robert) and Imogene Koenecke (Imogene), President and Secretary respectively, of Koenecke, applied for cigarette distributor's licenses in their individual capacities. Copies of these applications are attached to the Trustee's Request for Admissions as Exhibits A and A-1, respectively. (RA 9)

10. In their applications Robert and Imogene Koenecke set forth that they proposed to lease certain premises at 13136 S. Western Avenue in the City of Blue Island, Illinois, which were the same premises occupied by Koenecke, the bankrupt corporation. (RA 10)

11. Upon receipt of the applications of Robert and Imogene, the then Director of Revenue, Theodore Isaacs ("Isaacs") requested an opinion from the then Attorney General of Illinois, William G. Clark, as to the propriety of issuing distributor's licenses to Robert and Imogene. (RA 11)

12. Director Isaacs' request for an opinion from Attorney General Clark contained the following specific questions:

> "(1) Is the Department of Revenue required to withhold approval or withdraw approval of applicants' licenses for operation in view of their alleged and apparent status as figureheads and not distributors required to affix revenue stamps and account for their own sales and purchases? and,
>
> "(2) Is a distributor of cigarettes acting within the purview of the Cigarette Tax Act when it acts purely as a stamper for others who purport to be distributors? or,
>
> "(3) Is such a proposed arrangement for one company to affix cigarette tax stamps for another company or for other companies clearly without the law?" (RA 12)

13. In response, Attorney General Clark, on August 7, 1963 issued a written opinion (the Clark opinion) a copy of which (except for certain handwritten underscoring and emphasis marks appearing on the Exhibit which were placed there-

on by unknown third parties subsequent to its issuance) is Exhibit B attached to the Trustee's Request for Admissions. (RA 13)

14. In that response Attorney General Clark gave the following specific answers to Director Isaacs' three questions:

(1) Therefore, my answer to your first question is in the negative. (Clark Opinion p. 7).

(2) Therefore, in view of the facts as stated in your communication, my answer to your second question is in the affirmative. (Clark Opinion p. 10)

(3) In view of the foregoing observations it is obvious that my answer to your third question must be in the negative.

15. From that time on, up until August, 1968, the Department interpreted and construed the Clark opinion as authorizing and mandating the grant of multiple or secondary licenses to entities closely related to cigarette distributors even though it was obvious that such secondary licensees were mere figureheads and were to be utilized solely for the purpose of avoiding the effect of the graduated discount law, and thus continuing to obtain maximum discounts regardless of volume. (CARNEY, AM 47-84; CARNEY PM 4-8; 12-15, 18-19; INIGUEZ—Oct. 14, 54-71, Oct. 15, 51-56; JONES 28-30; 45; ICE 47)

16. In reliance upon the Clark opinion, the Department did issue distributor's licenses to Robert and Imogene, even though it was obvious that they did not actually intend to engage in business as distributors and that the sole purpose of applying for the additional licenses was to avoid the effect of the graduated discount law and enable the Koenecke corporation to continue to obtain the maximum discounts regardless of volume. (CARNEY 47-52) (KOENECKE 64)

17. Subsequently, Koenecke caused applications for distributor's licenses substantially similar to Exhibits A and A-1 to be filed in the names of an additional 53 or 54 separate individuals, all of whom were full or part-time employees of Koenecke. Each

of these applicants was granted a cigarette distributor's license by the Department even though it was obvious that none of those individuals intended actually to engage in business as distributors, and that the sole purpose of applying for these licenses was to avoid the effects of the graduated discount law and enable the Koenecke corporation to continue to obtain maximum discount regardless of volume. (For convenience, these individuals, including Robert and Imogene, are hereafter collectively referred to as the "Koenecke secondary licensees" and the licenses issued in their names will be called the "Koenecke secondary licenses"). (RA 17, CARNEY AM 57-61, INIGUEZ, Oct. 14, 54-71, Oct. 15, 51-56; KOENECKE 59-60).

18. By dividing its purchase of cigarette tax stamps among the 54 or 55 different licensees, Koenecke arranged matters so that no single licensee ever purchased more than $700,000.00 worth of stamps in any one fiscal year. (RA 18)

19. In addition to Koenecke, all other licensed Illinois distributors doing substantially more than the prescribed minimum volume, did, through affiliated entities, apply for a sufficient number of licenses so that except on rare occasions, no more than $700,000.00 in stamps were ever purchased under the same license in any one year. Exhibit C attached to the Trustee's Request for Admission is a true and correct list of these distributors who will collectively be hereinafter referred to as the "Other Volume Distributors." (RA 19; CARNEY AM 57-61; INIGUEZ Oct. 14, 47-Oct. 15, 51-56)

20. The Department of Revenue knew at the time that it issued each of the licenses applied for on behalf of entities affiliated with Other Volume Distributors that the purpose was to avoid the effect of the graduated discount law and to continue to obtain maximum discount regardless of volume. (RA 19; CARNEY AM 57-61; INIGUEZ Oct. 14, 54-71, Oct. 15, 51-56)

21. By use of the secondary license procedure both Koenecke and the Other Volume Distributors obtained the maximum dis-

count on substantially all stamps purchased between August 1, 1963 and July 31, 1968 regardless of the actual volume of stamps purchased during any one year. (RA 20)

22. None of the Koenecke secondary licensees ever intended to, or did, engage in business as distributors of cigarettes. (RA 21; CARNEY AM 64-84, SCAHILL, 30-31, INIGUEZ Oct. 14, 54-71, Oct. 15, 51-56; JONES 28, 30)

23. The Koenecke secondary licensees were utilized solely to purchase tax stamps at the maximum discount, which maximum discounts were substantially greater than the discounts which would have been available if the stamps had been purchased under the primary Koenecke license. (RA 22)

24. None of the secondary licensees affiliated with any of the Other Volume Distributors ever intended to or did engage in business as distributors of cigarettes. (RA 23, RA EX I, RA EX K; INIGUEZ, Oct. 14, 54-71, Oct. 15, 51-56; JONES 28, 30)

25. The secondary licensees affiliated with the Other Volume Distributors, were utilized by each of the other Volume Distributors, for the same purpose for which Koenecke used its secondary licensees; namely, in order to avoid the effect of the graduated discount law and thus continue to purchase tax stamps at the maximum discount, which discounts were substantially greater than the discounts which could have been available if all the stamps had been purchased under the primary licenses of the respective distributors. (RA 24; RA Ex I; RA Ex K, ICE, CARNEY PM 2-3; INIGUEZ Oct. 14, 54-71, Oct. 15, 51-56; JONES 32)

26. The purpose, manner and technique of use of licenses by each of the Other Volume Distributors was identical to the purpose, manner and technique of the use of secondary licenses by Koenecke. (Stip. 4; CARNEY PM 2; ICE 52; INIGUEZ Oct. 14, 55-56; JONES 32)

27. Koenecke duly caused to be filed, for each month from August, 1963 to and including June 30, 1968, for itself and for each of the Koenecke secondary licensees, full and complete cigarette tax returns setting forth, in the manner prescribed by law, the details of the stamping operations conducted by Koenecke and each of the Koenecke secondary licensees during each calendar month from August 1, 1963 to and including July 31, 1968. (RA 26)

28. Each of the tax returns was duly audited by the auditors of the Department assigned thereto. (RA 27)

29. The audits described in Paragraph 37 above included physical inspection and count of all cigarettes and cigarette tax stamps on hand at the beginning and end of each period. (RA 28)

30. The results of each of the audits was reported in writing to the Department by the auditor assigned by the Department to the audit of the Koenecke operations. (RA 29)

31. In substantially all instances, the auditor assigned by the Department to the Koenecke operation was one Walter Scahill, a long-time employee of the Department. (RA 30, SCAHILL 26ff)

32. Separate written audit reports were filed by Scahill with the Department for each of the 54 licenses used by Koenecke covering each month of operations from August 1, 1963 to and including June 30, 1968. (RA 31, SCAHILL 31ff.)

33. On each of the audit reports filed by Scahill with respect to each of the Koenecke secondary licensees, Scahill included the following statement:

> "Licensee acts as agency, in the purchase and affixation of tax revenue stamps, for the principal, F. W. Koenecke and Sons, Inc., 13136 South Western Avenue, Blue Island, Illinois." (RA 32)

34. At first, the legend described in Paragraph 33 was handwritten by Scahill on each audit report pertaining to a multiple license. (RA 33; SCAHILL 31)

35. Subsequently, Scahill expressly requested and obtained permission from his superior in the Department to purchase at state expense, a rubber stamp containing the legend described in Paragraph 33. (RA 34; SCAHILL 31)

36. Thereafter the legend described in Paragraph 33 was imprinted, by rubber stamp, on each audit report filed by Scahill with respect to each secondary licensee. (RA 35; SCAHILL 31-33)

37. It was obvious to Scahill from his examination of the premises and of the books and records that the only function of the secondary licensees was as a name through which stamps were purchased in order to maximize the discount. (SCAHILL 34-35; Stip 1-3)

38. The tax returns filed by Koenecke and the secondary licensees, which tax returns were audited by Scahill showed on their respective faces that each secondary licensee engaged in no activity whatsoever, except that for a period of approximately one week during each fiscal year it acted as nominal transferor to Koenecke of a quantity of unstamped cigarettes on which the total stamps would aggregate $700,000.00, and at the close of that one-week period acted as nominal transferor of the same number of stamped cigarettes. (Stip 1; SCAHILL 29-30)

39. The tax returns filed by Koenecke and its secondary licensees, together with Scahill's audit reports, showed on their faces that the transfers from the Koenecke corporation to the various secondary licensees were nothing more than mere bookkeeping entries and that the actual purchase and affixation of the stamps on those cigarettes were actually done by the Koenecke corporation and not by the secondary licensees. (Stip 1, 2; SCAHILL 29-30; 34-35)

40. The returns further showed on their faces that the method of determining the number of cigarettes shown as transferred from the Koenecke corporation to each secondary licensee was computed by working backwards from the number of tax stamps on which a maximum discount could be obtained and computing the number of cigarettes for which such tax stamps would be appropriate. (Stip 3)

41. When the multiple license procedure commenced, in 1963, Koenecke's clerical personnel did not know how to report on the monthly cigarette tax returns the supposed purchase and affixations of tax stamps by the secondary licensees. Scahill, the Department auditor, thereupon, at the request of Koenecke, instructed the Koenecke personnel how to compute and report the nominal transfers between the prime and secondary licensees which are described in findings Nos. 37-40, inclusive. (Cianci 16-35)

42. The cigarette tax returns filed by each of the Other Volume Distributors and their secondary licensees together with the audit reports made with respect thereto all showed on their respective faces that the manner of computing and reporting nominal transfers and the manner of purchasing and affixing stamps by their secondary licensees was precisely the same for each of the Other Volume Distributors as for Koenecke. (Stip. 4)

43. At no time during the period from August, 1963 to and including July 31, 1968, did the Department or any official thereof, question or challenge the propriety of the use by Koenecke and/or of the Other Volume Distributors of secondary licensees for the sole purpose of purchasing tax stamps at the maximum discount regardless of volume. (RA 40)

44. At no time during the period from August 1, 1963 to July 31, 1968 did the Department fail or refuse to sell to Koenecke and/or any of the secondary licensees tax stamps at the maximum discount so long as no more than $700,000.00 worth of stamps were purchased under one license in any one fiscal year. (RA 41)

45. During the period in question officials of the Department knowingly sold revenue stamps in response to purchase

orders given in the name of Alfred Koenecke, doing business as Alfred Distributing Company, one of the Koenecke secondary licensees, even after they personally knew that Alfred Koenecke was deceased. (KIELY 79-80)

46. From time to time, during the period in question, officials of the Department called Koenecke to advise it that its purchases under a particular secondary license had equalled or approached $700,000.00 and to recommend that it commence using a different license in order to continue at the maximum discount rate. (RA 41a)

47. From time to time during the period in question, the Department served notices of additional tax liability upon Koenecke for various tax deficiencies disclosed by the periodic audits conducted by Scahill. (RA 42)

48. Each of the deficiencies described in Paragraph 47 was duly paid by Koenecke on receipt of notice thereof, together with any and all penalties and interest applicable thereto. (RA 43)

49. None of the notices of additional liability described in Paragraph 47 asserted any liability of, or claim against Koenecke, by virtue of, or connected with, the purchase of tax stamps at maximum discount through the use of secondary licenses. (RA 44)

50. At no time during the period from August 1, 1963 to July 31, 1968, did the Department or any official thereof assert or indicate any intention to assert any claim or liability of any nature or description whatsoever against Koenecke, by virtue of, or connected with, the purchase of tax stamps at maximum discount through the use of secondary licenses. (RA 45)

51. At no time during the period from August 1, 1963 to July 31, 1968, did the Department or any official thereof assert any claim or liability against any Other Volume Distributor, by virtue of, or connected with the purchase of tax stamps at maximum discount through the use of secondary licenses (RA 46 KOENECKE 64)

52. During the entire period in question it was common knowledge among all officials of the Department having responsibility for administering the Cigarette Tax Acts that Koenecke and all Other Volume Distributors were using secondary licensees for the purpose and in the manner described above. CARNEY PM 2-3; INIGUEZ Oct. 14, 55-56; JONES 28-30; SCAHILL 39-40; ICE 21)

53. During the period in question, it was the accepted and established policy of the Department to grant distributor's licenses to any applicant therefor so long as the application appeared to be regular on its face. (CARNEY PM 3; INIGUEZ Oct. 14, 47 ff, Oct. 15, 51 ff; JONES 28-30)

54. During the period in question, it was the accepted and established policy of the Department to grant distributor's licenses to secondary licensees of volume distributors even though it was apparent from the face of the application and from the course of conduct previously entered into by that volume distributor and its existing secondary licensees that the sole purpose of the secondary licensee was to avoid the effect of the graduated discount law and to obtain the maximum discount regardless of volume. (CARNEY PM 4-7; INIGUEZ Oct. 14, 47ff, Oct. 15, 51 ff; KOENECKE 64)

55. During the period in question, that is, from August 1, 1963 to and including July 31, 1968, it was the accepted and established policy of the Department to permit volume distributors to use secondary licensees in the manner above described and thus obtain the maximum discount on all cigarette stamps regardless of volume purchased in any one year. (CARNEY PM 7; INIGUEZ Oct. 14, 47 ff; Oct. 15, 51 ff; JONES 29-30)

56. In August, 1968, the Department reversed its policy with respect to secondary licensees and adopted a policy whereunder licenses were granted only to entities who were actually physically transacting business as cigarette distributors in the full sense of the term. (CARNEY PM 7; JONES 34-35)

57. In accordance with the reversal of policy described above the then Director of Revenue of Illinois, Theodore Jones, during the month of August, 1968 issued a series of Executive Orders, copies of which are attached to the Request for Admission as Exhibits D1, D2 and E, respectively. (RA 47; JONES 33-35)

58. The Executive Orders described in Paragraph 70 (sic) resulted in the revocation of all secondary licenses of Koenecke and the Other Volume Distributors. (RA 48)

59. At the same time, i.e., on or about August, 1968, Director Jones directed Catherine Hanselman, an Executive Officer of the Department, to proceed retroactively to assess against all cigarette distributors, including Koenecke, the amounts of tax discounts obtained through the use of multiple licenses during the three fiscal years from July 1, 1965 to June 30, 1968. Exhibit F attached to the Trustee's Request for Admission is a true and correct copy of the directive issued by Catherine Hanselman pursuant to Director Jones' instructions. (RA 49 JONES 36-37)

60. In response to the directives described in Paragraph 72, the Department prepared an Analysis of Excess Discount wherein it tabulated:

A. The total discounts actually taken by Koenecke and each of the Other Volume Distributors during the three-year period;

B. The discounts which would have been available if all the stamps had been purchased under the main license;

C. The aggregate allegedly "excess discount" obtained through the utilization of multiple licenses. (RA 50)

61. Exhibit G attached to the Request for Admission is a true and accurate copy of the Analysis of Excess Discount described in Paragraph 73. (RA 51)

62. On or about September 16, 1968, the Department issued notices of additional tax liability against Koenecke and

each of the Other Volume Distributors described on Exhibit G for the Amount of Allegedly "excess discount" set opposite the name of each distributor. (RA 52)

63. The basis for determining the additional liability asserted against each of the Other Volume Distributors and the criteria employed in determining that each of the Other Volume Distributors were liable therefor was identical to the basis and criteria employed in computing and determining the alleged "additional liability" asserted against Koenecke. (JONES 32-33, 40; HANSELMAN 75-77; SCOBBIE 56-57)

64. Koenecke and all but three of the Other Volume Distributors described on Exhibit G protested the notice of additional liability described in Paragraph 75 and requested hearings thereon before the Department in accordance with applicable law. (RA 54)

65. This bankruptcy proceeding was initiated before the commencement of any hearings on the notice of additional liability issued against Koenecke. (RA 55)

66. A restraining Order was entered by this Court on March 14, 1969 restraining the Department from conducting the hearing or from proceeding in any manner with respect to the alleged additional liability against Koenecke other than by filing a Proof of Claim in this proceeding. (RA 56)

67. On April 8, 1969, the Department filed Claim No. 6 in this proceeding, asserting the identical liaibility which was asserted against Koenecke in the notice of additional liability based on the Analysis of Excess Discount attached hereto as Exhibit G. (RA 57)

68. In the case of the Other Volume Distributors, hearings were held in connection with the following 13 distributors, all of whom maintained their principal place of business within Cook County, Illinois:

Public Vending Corporation
Northwestern Candy and Tobacco Co., Inc.
A. R. Patrick Wholesale, Inc.

Midway Tobacco Company
Northwestern Notion and Tobacco Co., Inc.
M. Rosenberg & Co., Inc.
Gershuny & Epstein, Inc.
Calumet Candy Company
O. H. Bambas Tobacco Co., Inc.
S. Bloom, Inc.
Meyer Silverstein
Walgreen Co. (Illinois)
Zenith Vending Corporation

69. Twelve of the hearings, i.e., all of the foregoing except that of Zenith Vending Corporation were conducted by Hearing Referee Barry Semer. Exhibits H-1 to H-12 inclusive, which are incorporated in the appendix attached to and made part of the Request for Admissions heretofore filed by the trustee are true and correct transcripts of those hearings. (RA 59)

70. At the conclusion of the hearings described in Paragraph 69, Hearing Referee Semer issued a written memorandum pertaining to all of those hearings. Exhibit I attached to the Request for Admissions is a true and correct copy of that memorandum ("the Semer Memorandum"). (RA 60)

71. The Department accepted and approved the Semer Memorandum, and thereupon cancelled the notice of liability which had been issued against each of the twelve distributors described in Paragraph 75. Exhibits J-1 to J-12, inclusive, to the Request for Admissions stipulation are true and correct copies of the Department Official Hearing Disposition Reports pertaining to each of those twelve distributors. (RA 61)

72. With regard to Zenith Vending Corporation, a hearing was conducted by Hearing Referee Ronald Grossman. Exhibit H-13 to the Request for Admissions to the stipulation is a true and correct transcript of that hearing. (RA 62)

73. At the conclusion of the hearing described in Paragraph 85, Hearing Officer Grossman issued a memorandum pertaining thereto (the Grossman Memorandum) a true and correct

copy of which is attached to the Request for Admissions as Exhibit K. (RA 63)

74. The Department accepted and approved the Grossman Memorandum and thereupon cancelled the notice of additional liability which had been issued against Zenith Vending Company. Exhibit J-13 to the Request for Admissions is a true and correct copy of the Department Official Hearing Disposition Report pertaining to Zenith Vending Corporation. (RA 64)

75. With regard to the following distributors, all of whom were located in Illinois outside Cook County (hereinafter "the Downstate Volume Distributors") no hearings were conducted by the Department: (RA 65)

Weeke Wholesale Company
Aurora-Eby-Brown Company
Rock Island Tobacco & Specialty Company
Elgin Eby-Brown Company
Chambers & Owen, Inc.
M-C Sales, Inc.
J. Meyer & Company
Walter C. Knack Company
McHenry Eby-Brown Company
Springer Burklund Company

76. The Department did not conduct hearings in the case of the Downstate Volume Distributors because the Department concluded that, for the reasons set forth in the Semer Memorandum, there was no basis in law for assertion of liability against any of the Downstate Volume Distributors. (RA 66)

77. The conclusion of the Department not to proceed with hearings on the assessments against the Downstate Volume Distributors was set forth as follows in the Department Official Hearing Disposition Reports submitted by Willard Ice, then Supervisor of Rules and Regulations of the Department:

> I am attaching a copy of Barry E. Semer's memorandum of June 30, 1969 to Mr. David Sarver concerning some Cook County Cigarette Tax Notices of Tax Liability cases which are identical with this case except for the amount

and the name of the taxpayer involved. If we accept Barry Semer's recommendation, (as I believe we should do), I do not believe we need to hold a formal hearing in this case because it involves strictly a legal issue (there are no factual questions), and I am sure the taxpayer is not going to object to having the Notice of Tax Liability reduced to a zero amount.

For the reasons given in Mr. Semer's memorandum, which is incorporated into this hearing recommendation and made a part thereof, I recommend that this Notice of Tax Liability be disposed of through the issuance of a Final Assessment in a zero amonut. (RA 67; ICE 38ff)

78. The notices of tax liability asserted against each of the Downstate Volume Distributors were thereupon cancelled in their entirety. Exhibits J-14 to J-24, to the Request for Admissions are true and correct copies of the Official Hearing Disposition Reports pertaining to the Downstate Volume Distributors. (RA 67)

79. The Department cancelled the notices of tax liability asserted against each of the Other Volume Distributors without making any investigation as to the genuineness of the signatures on any of the applications for licenses or tax returns filed on behalf of any of the secondary licensees affiliated with the Other Volume Distributors and without receiving, seeing or hearing any evidence or testimony as to whether any or all of such signatures were genuine. (ICE 41-43)

80. Subsequent to issuing the notices of tax liability against Koenecke and the Other Volume Distributors (Finding No. 61 above) the Department commenced investigations which disclosed that in some instances Robert Koenecke had signed the names of secondary licensees to applications and documents. (Stip. 10)

81. Neither the investigations described in Paragraph 80, nor any information obtained through such investigations played any part in the decision of the Department to make the retroative assessment or to issue the notice of tax liability which forms the basis for Claim No. 6. (Stip. 10)

82. In each instance where Robert Koenecke signed the name of a secondary licensee to any application or other document, Robert Koenecke had the express or implied authority of the person whose name was so signed. (KOENECKE 60-62, 69, 72, 80)

83. During the period in question, i.e. from August, 1963 to July 30, 1968, it was common knowledge among the employees of the Koenecke corporation that the names of numerous employees were being used in order to obtain secondary licenses and thus qualify for the maximum discount, regardless of volume of stamps purchased. (KOENECKE 60-62; KLOPP 59; CIANCI 13)

84. All of the Koenecke secondary licenses were, at all times from and after issuance, publicly displayed on a bulletin board in the common workroom of the Koenecke premises. (KOENECKE 62; CIANCI 34-35)

85. During the period in question, that is, from August 1, 1963 to and including June 30, 1968, Koenecke based its prices to its customers on the assumption that it was entitled to receive the maximum discount obtainable through the use of secondary licensees. The benefits of the maximum discounts were thus in large part passed on to Koenecke's customers. (KOENECKE 59, 66)

86. During the period in question the net operating profit of Koenecke and the salaries paid to the executives even after receiving the maximum discounts, were only minimal. (KOENECKE 63)

87. None of the financial statements issued by Koenecke during the period showed any liability for return of allegedly excess discounts. These financial statements were regularly distributed to suppliers. (KOENECKE 63, 65-67)

88. Koenecke did not intend to, and in fact did not, at any time, deceive or mislead the State of Illinois or the Department, or any official or officer thereof by any act or omission of any nature with respect to the case of multiple or secondary

licensees or the purchase of tax exempts at maximum discounts. (CARNEY AM 87-89, PM 2-8; INIGUEZ Oct. 14, 71; JONES 28-30, 35-36, 45, 48 Stip. 1-4, inc.; KOENECKE 84-88)

89. The Department actively participated in the Statewide procedure whereunder Koenecke and the Other Volume distributors obtained and used multiple licenses to avoid the effect of the graduated discount law, and thus obtain the maximum discount regardless of volume. (RA 1-67 Stip. 1-4; CARNEY AM 46ff, PM 2ff; INIGUEZ Oct. 14, 47ff, Oct. 15, 51ff; SCAHILL 26-40; CIANCI 16-35; KOENECKE 64)

Conclusions of Law

1. This court has full and complete jurisdiction to hear and determine the validity of the tax claim asserted by the State of Illinois, the same not having been heard or adjudicated prior to bankruptcy by a court or administrative tribunal. Bankruptcy Act § 2a(2A) 11 USC 8.

2. All actions of the Attorney General of Illinois, and of the Department and its officials and employees described in Findings 1 to 89, hereinabove, were official actions of the State of Illinois (the State).

3. The State is charged with knowledge of all facts known to the Department and/or the Attorney General, as described in Findings of Fact Nos. 1-83, hereinabove.

4. The State actively participated in the procedures whereby Koenecke, and virtually all other Volume Distributors obtained and used secondary or multiple licenses in order to avoid the effect of the Graduated Discount Law and thus obtain maximum discount regardless of volume.

5. Because of its active participation therein, the State is estopped from asserting any liability against Koenecke or this estate arising out of its use of multiple licenses for the above purpose. *New Mark Builders* v. *City of Aurora,* 1968, 90 Ill.

App. 2d 98, 233 N. E. 2d 44, 46-47; *Hickey* v. *Illinois Central Railroad Co.,* 1966, 35 Ill. 2d 427, 220 N. E. 2d 415, 426; *City of Quincy* v. *Sturhaan,* 1960, 18 Ill. 2d 604, 165 N. E. 2d 271, 277.

6. To the extent that the State's claim is based on alleged fraud and/or misrepresentation it is essential for the State to establish by a preponderance of evidence that:

A. Koenecke knowingly and wilfully misrepresented facts to the State or the Department.

B. Koenecke intentionally deceived and misled the State and/or the Department.

C. The State and/or the Department was in fact deceived and misled by such misrepresentations and relied thereon to its detriment.

7. The testimony heard and evidence received not only fails to sustain the burden described in conclusion No. 6, but actually establishes that no misrepresentation was made by Koenecke, and that neither the State nor the Department were deceived or misled as to any material fact.

8. It would be unreasonable and inequitable to apply retroactively the policy first adopted by the Department in August, 1968, after Koenecke had during the preceding five-year period consistently entered into contractual relationships based on the accepted practices, procedures and policies which prevailed during that time. *Pressed Steel Car Co.* v. *Lyons,* 1955, 7 Ill. 2d 95, 129 N. E. 2d 765, 771.

9. The policy considerations against retroactive legislation apply with equal force to retroactive administrative reversals of policy which have the force of law. *Pressed Steel Car Co.* v. *Lyons,* 1955, 7 Ill. 2d 95, 129 N. E. 2d 765, 771.

10. The Department is bound by its own audits conducted throughout the period from 1963 to 1968, in which audits it failed to assert any liability whatsoever for discount obtained through multiple licenses, even though the auditors and the Department were fully aware of the prevailing practice.

11. The facts and the legal issues before the Department in the cases of the Other Volume Distributors were, in all material respects, identical to the facts and the legal issues now before the Court.

12. The quasi-judicial administrative decision of the Department that no liability was incurred by any of the Other Volume Distributors who used multiple licenses to obtain maximum discount in precisely the same manner as did Koenecke is *res judicata* that Koenecke also incurred no such tax liability.

13. All of the Cigarette distributors, including Koenecke, were entitled to equal application and enforcement of the Illinois Cigarette Tax statutes. Koenecke, and this estate have a federally protected right to the application and enforcement of the Illinois Cigarette Tax statutes without intentional or purposeful discrimination. *Weisberg* v. *Powell*, 7 Cir., 1969, 417 F. 2d 388, 392.

14. The attempt by the State to impose retroactive tax liability against Koenecke, after disallowing all claims of similar liability against Other Volume Distributors constitutes intentional and purposeful discrimination against Koenecke and this estate.

15. Koenecke is not indebted to the State of Illinois for all or any portion of the amount asserted in Claim No. 6.

16. Even if all or any portion of Claim No. 6 were valid under State law, it would be unconscionable and inequitable and contrary to the equitable principles which control bankruptcy proceedings to permit any portion of the claim to participate on a parity with, or prior to, the claims of general unsecured creditors. *Pepper* v. *Litton* (1939), 308 U. S. 295; 304-5, 308, 84 L. Ed. 281; 60 S. Ct. 238, *Collier* on Bankruptcy, Vol. 3 ¶ 57.14 pp. 211-212.

17. Claim No. 6 filed by the State for $1,268,334.60 is invalid as a matter of law and should be disallowed.

ORDER.

It is therefore ordered, that:

1. Claim No. 6 filed by the Department of Revenue of the State of Illinois as a tax claim entitled to priority in the sum of $1,268,334.60 is hereby disallowed in its entirety.

2. Any Findings of Fact in this Order which may be deemed to contain, or to constitute, any conclusion of law is hereby determined as a matter of law; every conclusion of law in this order which may be deemed to contain, or to constitute any finding of fact, is hereby found as a fact.

Enter

/s/ ELMER P. SCHAEFER,
Bankruptcy Judge.

7-25-74.

EXHIBIT A.

KEY TO ABBREVIATIONS.

Abbreviations	Explanations
RA	Trustee's Request for Admissions and State's Response thereto.
Stip	Stipulation filed March 21, 1974.
CARNEY AM	Transcript of testimony of HILDREN CARNEY, March 18, 1974, 1:30 P.M.
INIGUEZ-Oct 14	Transcript of examination of JOSEPH INIGUEZ, October 14, 1969.
INIGUEZ-Oct. 15	Transcript of examination of JOSEPH INIGUEZ, October 15, 1969.
JONES	Transcript of testimony of THEODORE JONES, March 21, 1974.
ICE	Transcript of Deposition of WILLARD ICE, February 20, 1974.
KOENECKE	Transcript of testimony of ROBERT KOENECKE, March 21, 1974.
SCAHILL	Transcript of testimony of WALTER SCAHILL, March 21, 1974.
CIANCI	Transcript of testimony of NICHOLAS CIANCI, March 20, 1974.
KIELY	Transcript of examination of JOSEPH KIELY, October 14, 1969.
HANSELMAN	Transcript of examination of CATHERINE HANSELMAN, November 18, 1969.
SCOBBIE	Transcript of examination of JOHN SCOBBIE, November 19, 1969.
KLOPP	Transcript of testimony of EDWARD KLOPP, March 20, 1974.

EXHIBIT A.

GLENN R. HEYMAN, Trustee, etc., *Appellant*,

No. 42544 *vs.*

GEORGE E. MAHIN, Successor Director of the Department of Revenue of the State of Illinois, et al., *Appellees.*

} Appeal from Circuit Court Cook County

Docket No. 42544—Agenda 43—May, 1970.

GLENN R. HEYMAN, *Trustee, Appellant* v. GEORGE E. MAHIN, *Director of Revenue, et al., Appellees.*

MR. JUSTICE CREBS delivered the opinion of the court:

The question presented by this appeal is whether the graduated discounts allowed distributors under the Cigarette Tax Act (Ill. Rev. Stat. 1969, ch. 120, par. 453.2) violate the uniformity provision of section 1 of article IX of the Illinois constitution and the equal-protection clause of the Federal constitution.

F. W. Koenecke & Sons, Inc., filed its amended complaint in the circuit court of Cook County seeking a declaration that the 1963, 1965, 1967 and 1968 amendments to section 2(b) of the Cigarette Tax Act are unconstitutional and sought to recover sums of money paid to the State under protest. A motion to dismiss was filed by defendants, the Director of the Department of Revenue, the State Treasurer, and the Attorney General. Thereafter, Glenn R. Heyman, as trustee in bankruptcy of the plaintiff, was permitted to join the action and the amended complaint was adopted by him as his pleading. The circuit court found each of the amendatory acts to be constitutional and dismissed the amended complaint. Appeal from that judgment is directed to this court pursuant to Rule 302(a)(2).

The Cigarette Tax Act as originally enacted in 1941 levied a tax on persons engaged in business as distributors of cigarettes in this State measured by the number of cigarettes sold or otherwise disposed of in the course of such business in this State and allowed each distributor a 5% discount on the amount of tax remitted to the State. (Ill. Rev. Stat. 1941, ch. 120, par. 453.2) The Act was later amended to declare that the impact or incidence of the tax was on the retailer, but the distributor remained responsible for payment of the tax and entitled to the discount on the amount of tax remitted to the State. (Ill. Rev. Stat. 1965, ch. 120, par. 453.2.) This amendment changing the incidence of the tax was apparently passed to give the consumer a deduction on his Federal income tax return. 52 I. B. J. 124, 135.

In 1963 the flat 5% discount rate granted to cigarette distributors was discontinued and replaced with a graduated declining discount rate measured by the dollar amount of tax stamps purchased in any year commencing July 1 and ending June 30 of the following year. (Ill. Rev. Stat. 1963, ch. 120, par. 453.2.) The discount rate schedule adopted in 1963 and its revisions in 1965 and 1967 are as follows:

1963 Amendment.

First $700,000 of tax paid	—5% discount
Second $700,000 of tax paid	—4% discount
Third $700,000 of tax paid	—3% discount
All additional tax paid	—2% discount

1965 Amendment.

First $700,000 of tax paid	—2 6/7% discount
Second $700,000 of tax paid	—2 2/7% discount
Third $700,000 of tax paid	—1 5/7% discount
All additional tax paid	—1 1/7% discount

1967 Amendment.

First $700,000 of tax paid	—2 2/9% discount
Second $700,000 of tax paid	—1 7/9% discount
Third $700,000 of tax paid	—1 1/3% discount
All additional tax paid	—8/9% of 1% discount

The 1968 amendment continued the discount rate of the 1967 amendment.

F. W. Koenecke & Sons, Inc., was chartered in 1953 as the legal successor to a family business started in 1881 and is the largest cigarette distributor in the Midwest. Its business is the import purchasing of cigarettes from the manufacturer and the selling of the cigarettes to wholesalers and retailers both inside and outside of the State. Being a distributor within the definition of the Cigarette Tax Act, it must purchase cigarette tax stamps from the State and affix the stamps to each package of cigarettes it sells in the State.

Cigarettes purchased by plaintiff are shipped to its plant in standard cases. Each case contains 60 cartons with 10 packages of 20 cigarettes in each carton or a total of 600 packages of cigarettes in each case. Each case must be opened, all 60 cartons are removed and opened, a tax stamp is affixed to each of the 600 packages, and the cartons are then resealed and replaced in the case. Plaintiff has special machinery, equipment and personnel to perform this operation.

Plaintiff purchases approximately $700,000 of tax stamps a week and about $40,000,000 of the stamps in the course of a year. This volume of tax stamp purchases puts plaintiff in the lowest discount bracket within the first month of a year's operation. The complaint also alleges that the minimum discount is not sufficient to cover its costs for collecting the cigarette tax and that the cost of collecting the tax does not decrease with the increased amount of tax collected.

Assuming the allegations of plaintiff's complaint to be true, the inverse volume discount is discriminatory and places a heavier burden on the larger distributors. Of course, the Illinois and Federal constitutions only protect a taxpayer from invidious discrimination (*Doolin* v. *Korshak*, 39 Ill. 2d 521; *Metropolis Theatre Co.* v. *City of Chicago*, 228 U. S. 61, 57 L. Ed. 730, 33 S. Ct. 441) and the fact that a tax bears more heavily on one taxpayer than another does not of itself violate the uniformity

provision of the Illinois constitution or the equal-protection clause of the Federal constitution. *Grenier & Co.* v. *Stevenson*, 42 Ill. 2d 289; *Fox* v. *Standard Oil Co. of New Jersey*, 294 U. S. 87, 79 L. Ed. 780, 55 S. Ct. 333.

We note initially that the cigarette tax is imposed at a flat rate measured by the number of cigarettes sold. It is clear that if the tax were imposed at a graduated rate measured by the number of cigarettes sold, it would be unconstitutional. In *Stewart Dry Goods Co.* v. *Lewis*, 294 U. S. 550, 79 L. Ed. 1054, 55 S. Ct. 525, the Supreme Court held that a graduated tax on retailers measured by the gross receipts from sales violated the equal-protection clause of the fourteenth amendment. The court found there was no reasonable relation of gross sales to net profit and consequent ability to pay; and, therefore, there exists no reasonable relation of a tax measured by gross sales to the value of the privilege of merchandising. It concluded by stating: "The law arbitrarily classifies these vendors for the imposition of a varying rate of taxation, solely by reference to the volume of their transactions, disregarding the absence of any reasonable relation between the chosen criterion of classification and the privilege the enjoyment of which is said to be the subject taxed. It exacts from two persons different amounts for the privilege of doing exactly similar acts because the one has performed the act oftener than the other." 294 U. S. 550, 566, 79 L. Ed. 1054, 55 S. Ct. 525, 532.

The expressed purpose of the graduated discount allowed to distributors under the Cigarette Tax Act is to cover the distributors' cost of collecting the tax imposed by the Act. Plaintiff asserts, however, that there is no reasonable relationship between the graduated discount and the cost of collecting the tax. It first points out that the amended complaint alleges, and that it is prepared to prove, that the minimum discount allowed under the Act is not sufficient to cover its cost of collecting the tax and that the cost of collecting the tax does not decrease with increased collections of the tax.

It also refers to the fact that in 1963, when the graduated discount was introduced, the cigarette tax was 6¢ per package; that the discount brackets have not been changed since that time; that the discount rates have been reduced; and that the tax has been raised to 12¢ per package. It states that even without the reduction in the discount rates, the increase of the tax rate without changing the discount brackets has reduced the discount during a period of increased costs of collecting the tax and demonstrates that there is no reasonable relation between the statutory discount and the cost of collecting the tax.

Plaintiff has also attached to its brief, as an exhibit, a summary of statutes from other States which impose a cigarette tax. The exhibit shows that, except for Hawaii, all States and the District of Columbia impose a tax on cigarettes and require the affixing of a tax stamp or meter mark on each package of cigarettes. Each State allows the person required to affix the stamp or meter mark a discount. Twenty-four States expressly provide that the purpose of the discount is to compensate for the cost of affixing the stamp or meter mark. There is a great variation in the discount rates allowed by the various States ranging from 9% in Louisiana to .85% in California. Another exhibit shows the dollar amount of discount allowed per 1,000 packages of cigarettes varies from $7.50 in Alabama to 70¢ in Michigan. Plaintiff states these exhibits demonstrate that although the purpose of the discount in all States is to compensate for the cost of affixing the tax stamps or meter marks and although the cost of doing so would be approximately the same in all States, there is a great divergence among the States as to rate of discount and the amount of discount. The conclusion plaintiff draws from these exhibits is that the legislative judgments in this field have been arbitrary.

We note parenthetically that the exhibits indicate there are five other States—Florida, Minnesota, New Mexico, New York, and North Dakota—that use a graduated discount. Apparently

the constitutionality of the graduated discount has never been challenged in those States.

It is apparent that the graduated discount which is geared to the volume of cigarettes sold in a year has the same ultimate effect as the graduated tax measured by gross sales which was condemned in *Stewart Dry Goods*. Furthermore, the exhibits and allegations of plaintiff's complaint tend to support its contention that there is no reasonable relation between the graduated discount and the cost of collecting the tax, and defendants have not argued that there is such a relationship. The statute itself, however, states that the discount is to cover the cost of collecting the tax and by graduating the discount it implies that the cost of collection decreases with the number of stamps bought and affixed.

The legislature, of course, has broad powers to enact taxing laws which affect some persons differently than others as long as there is a reasonable state of facts to justify the discrimination (*Doolin* v. *Korshak*, 39 Ill. 2d 521); and a determination by the legislature is presumed supported by facts known to it unless facts judicially known (*Ohio Oil Co.* v. *Wright*, 386 Ill. 206) or proved (*Donovan* v. *Holzman*, 8 Ill. 2d 87) show otherwise. We are of the opinion that the facts alleged in the complaint conflict with the legislative determination to such an extent that the graduated discount would be invalid, and plaintiff is entitled to an opportunity to prove these allegations.

The judgment of the circuit court of Cook County is reversed and the cause is remanded for further proceedings.

Reversed and remanded.

UNITED STATES DISTRICT COURT,
Northern District of Illinois,
Eastern Division.

In Re F. W. KOENECKE & SONS, INC., an Illinois corporation, *Bankrupt.* DEPARTMENT OF REVENUE, STATE OF ILLINOIS, *Claimant-Appellant,* *vs.* GLENN R. HEYMAN, *Trustee-Appellee.*	In Bankruptcy Case No. 69 B 1647

FACTS.

The bankrupt (Koenecke) was the largest cigarette distributor in Illinois. As such, it was required by state law to collect and remit the state tax imposed on the sale and use of cigarettes. (Ill. Rev. Stat., Ch. 120, ¶¶ 453.1-453.67) The statutory procedure requires the distributor to prepay the tax and to affix stamps evidencing such payments to the packages of cigarettes. For their services, distributors are entitled to a discount which, until 1963, was a flat 5 percent of the purchase price of the stamps. In 1963, the discount formula was amended by the legislature and the percentage declined as the volume increased.

The maximum discount was fixed at 1⅔ per cent of the first $700,000 of tax paid, reduced to 1⅓ per cent of the next $700,000, 1 per cent of the next $700,000, and ⅔ of 1 per cent of all additional tax paid. Koenecke's volume was so large that

the minimum discount bracket was reached in the first three weeks of each year.

In an effort to avoid the effect of the new formula Robert Koenecke, the principal shareholder and president of Koenecke and his wife, Imogene, the secretary of Koenecke, shortly after the enactment of the 1963 amendments, filed individual applications for cigarette distributor's licenses.

Upon receipt of these applications, the then Director of the Department of Revenue, Theodore Isaacs, requested a legal opinion from the then Attorney General, William J. Clark, as to the propriety of issuing such licenses. In his opinion, the Attorney General held that licenses could be issued to persons closely related to an already licensed distributor and operating from the same address provided that separate applications were made by each licensed distributor which conformed to the statute, the applicant fully qualified under the provisions of the statute and the applicants were "qualified distributors and not merely persons 'who purport to be distributors.' "

After receipt of this opinion, the Director issued separate licenses to the two Koeneckes. Thereafter, the Department of Revenue uniformly issued separate licenses to entities and individuals closely related to licensed cigarette distributors even though it was apparent, and the Department knew, that the additional "licensees" were not separate distributors and were being utilized solely for the purpose of avoiding the new reducing discount formula. As a result, all large scale Illinois cigarette distributors applied for and received a sufficient number of additional licenses in each year so that no more than $700,000 in stamps was ever purchased by any "licensee" in any year and all received the maximum discount. In Koenecke's case, more than 52 licenses were obtained each year, primarily in the names of company employees.

This practice continued until 1968 when a new Director of the Department of Revenue, Theodore Jones, determined that

the practice which had ben accepted by the department for five years was contrary to the Attorney General's opinion and the statute. He ordered all the so-called "secondary licenses" cancelled and directed his staff to make audits of the accounts of all primary licensee-distributors for the purpose of assessing them the difference between the amounts actually paid by them and the amounts they would have paid without the contrived licenses and discounts. As a result, deficiencies were assessed against some 27 distributors, including Koenecke, all of whom filed administrative protests. In addition, Koenecke filed suit in the Circuit Court of Cook County challenging the constitutionality of the discount formula.

The instant bankruptcy proceedings were instituted prior to any hearings before the Department of Revenue. On motion of the petitioning creditors, the Bankruptcy Court enjoined any further administrative proceedings before the Department on Koenecke's protest and authorized the trustee in bankruptcy to prosecute the court suit. The Department thereupon filed an alleged tax claim for $1,268,334.60 in the bankruptcy proceedings. The trustee objected to the claim, the State answered and the referee disallowed the claim with findings of fact, conclusions of law and an opinion. The instant appeal followed.

While the proceedings with respect to the claim were going forward in the Bankruptcy Court, the Department of Revenue conducted hearings in connection with the protests of the 13 distributors other than Koenecke located in Cook County. The hearing officer who conducted 12 of the hearings found:

> The Department, acting in the governmental role of tax collector, has by its conduct "comforted" each licensee into assuming that the discounts were allowable. The Department knew that the multiple licenses were set up for the sole purpose of earning maximum discounts and in fact, cooperated actively with the licensees in determining the most advantageous point at which to begin purchasing on another license. These circumstances affected the pricing policy of the licensees. To assess and collect the sought

> after tax would cause the licensee to absorb the tax which was never intended by the Illinois Cigarette Tax Act. Such tax collection policies, being unjust and inequitable, should not be be allowed.

The hearing officer who conducted the one remaining hearing concluded:

> It is the opinion of the undersigned that the Department's passive and active conduct in knowingly permitting and encouraging multiple licensing, and the Attorney General's written opinion, create an estoppel against the State in its attempt to successfully realize the amount claimed herein.

The Department accepted the conclusion of the two hearing officers and cancelled in their entirety the proposed deficiency assessments against the 13 Cook County distributors other than Koenecke. In addition, without further hearings, the Department also cancelled the proposed assessments against all of the other distributors. The only proposed deficiency assessment not cancelled by the Department was that against Koenecke, action on which had been enjoined by the Bankruptcy Court. The foregoing cancellations were all approved by George Mahin, the then Director of Revenue.

The case in the Circuit Court of Cook County, meanwhile, went forward and the trial judge held the statutory formula constitutional. His holding was affirmed by the Illinois Supreme Court, 49 Ill. 2d 284. The United States Supreme Court denied certiorari.

In addition to finding the foregoing facts, all of which are undisputed, the referee also made a substantial number of additional findings of fact which we adopt and incorporate by reference herein with one exception. His finding No. 82 reads:

> 82. In each instance where Robert Koenecke signed the name of a secondary licensee to any application or other document, Robert Koenecke had the express or implied authority of the person whose name was so signed. (Koenecke 60-62, 69, 72, 80)

Since 36 former Koenecke employees whose names were used to obtain secondary licenses, either through depositions or signed statements, denied authorizing anyone to sign their names to license applications and only Robert Koenecke testified to the contrary, the referee's finding in this one regard is clearly erroneous and we do not adopt it. We do, however, adopt his findings 83 and 84 that it was common knowledge among Koenecke employees that the names of numerous employees were being used to obtain secondary licenses and that at all times from and after issuance of the secondary licenses they were publicly displayed on a bulletin board in the common workroom of the company.

Conclusions of Law and Opinion.

A. Estoppel.

In support of its appeal from the referee's ruling, the Department of Revenue challenges his conclusion and, incidentally, that of its own two hearings officers, with respect to the application of the doctrine of estoppel to the facts of this case. All three concluded that, in view of the state's active and passive participation in the "secondary licensee" practice and the reliance of Koenecke and other volume tobacco distributors on the state's acceptance of the practice in fixing their prices, it would be unjust and inequitable for the state to attempt retroactively to collect the proposed deficiencies and the State should be estopped from doing so.

The State contends that the doctrine of equitable estoppel cannot be used to deprive a sovereign state of public revenues because of mistaken application of the law by state revenue officials. In support of its contention, the State cites a number of decisions by Illinois and other courts, declining to apply the estoppel doctrine in the particular cases. See e.g., *People* v. *Charles Levy Circulating Co.*, 17 Ill. 2d 160; *Austin Liquor Mart* v. *Department of Revenue*, 51 Ill. 2d 1; *Clare* v. *Bell*, 378 Ill. 128; *People* v. *Bradford*, 372 Ill. 63; *State* v. *Board of City*

Commissioners, 107 P. 2d 542. It particularly relies on the decision of the Illinois Supreme Court in ***People ex rel. Scott*** v. *Chicago Thoroughbred Enterprises, Inc.,* 56 Ill. 2d 210. In that case, the taxpayer owned and operated two race tracks. It computed its taxes separately on the amounts wagered at each track and for five years paid graduated taxes on this basis. The State contended that, under the applicable statute, the separation of the two tracks was improper and asserted deficiences for additional taxes computed on a consolidated basis. The Supreme Court agreed and, in rejecting the application of the doctrine of estoppel, said, p. 220:

> Our decisions, however, have made it clear that the doctrine of estoppel cannot be invoked where governmental authorities of the State are concerned, particularly those relating to the public revenues, except in extraordinary circumstances.

We agree with the Illinois Supreme Court and the State that, "except in extraordinary circumstances" the sovereign, State or Federal, is not subject to the doctrine of estoppel in tax matters. The mere fact that no challenge has been made to a taxpayer's interpretation and application of revenue statutes or regulations in one or more years does not estop the government from challenging them later.

As the trustee points out, however, if there ever was or could be a case where the circumstances were so extraordinary as to justify estoppel against the State, this is the case. Here, the State Department of Revenue, actively participated in the operation of the multiple licensee scheme not only with Koenecke but every other large volume tobacco distributor in the state, including advising them how and when to file additional applications for secondary licenses. It knowingly accepted reports and audits reflecting the scheme. Relying on the State Revenue Department's acquiescence and participation in the scheme, the distributors fixed their resale prices lower than they otherwise would have and, in effect, passed the benefits of the

higher discounts on to their customers. Finally, the State, through the Department of Revenue, determined on virtually identical facts that the doctrine of estoppel was applicable in the cases of all distributors other than Koenecke and presumably would have done so with respect to Koenecke as well had it not been enjoined by the Bankruptcy Court from so doing.

The doctrine of estoppel is an equitable one. The observations of the Illinois Supreme Court in *People* v. *Thomas,* 361 Ill. 448, at 456, are particularly pertinent here:

> The doctrine of estoppel may be invoked against a municipal corporation where there have been positive acts by the municipal officers which may have induced the action of a party and where it would be inequitable to permit the corporation to stultify itself by retracting what its officers had done, but mere non-action is not sufficient to work an estoppel. (*Trustees of Schools* v. *Village of Cahokia,* 357 Ill. 538; *Melin* v. *Community Consolidated School District No. 76,* supra; *Logan County* v. *City of Lincoln,* 81 Ill. 156.) In applying this doctrine the courts will not decide the question by the mere lapse of time but by all the circumstances of the case, and hold the public estopped or not, as right and justice may require. (*Trustees of Schools* v. *Village of Cahokia,* supra; *Martel* v. *City of East St. Louis,* 94 Ill. 67; *Chicago, Rock Island and Pacific Railroad Co.* v. *City of Joliet,* 79 id. 25.)

Given the extent of the State's participation, the economic effects on the taxpayers and the fact that the State has acknowledged the application of the doctrine of estoppel to itself in the cases of all distributors other than Koenecke, we conclude that the referee correctly applied the doctrine here.

B. *Unclean Hands.*

The State also contends that a trustee has no greater rights than a bankrupt and, since Robert Koenecke signed the names of some employees to applications for secondary licenses without their consent, he had unclean hands and the trustee, therefore,

is not entitled to equitable relief. Two observations dispose of this contention. First, as the trustee points out, it is not a correct conclusion that the trustee stands only in the shoes of the debtor. Section 70c of the Bankruptcy Act (11 U. S. C. § 110c) confers on the trustee powers not possessed by the debtor and other sections empower the trustee to set aside transfers and security interests in situations in which the bankrupt has been guilty of actual or constructive fraud which would obviously preclude his acting similarly. Still other sections limit the collection of penalties from a trustee even though they would have been enforceable againt the bankrupt and arise from his violation of state or federal law.

Second, the filing of applications in the names of employees without their consent, does not constitute "unclean hands" so far as the State is concerned. State employees participated actively and passively in the whole multiple licensee scheme. It made no apparent difference to them whether or not the applicants personally signed the applications or consented to their names being used. The whole process was a sham as all involved well knew. The employees were likewise aware that their names were being used, with or without their consent. The statements and depositions of Koenecke employees do not suggest that they were unaware of the scheme, merely that they did not consent to their names being used.

We conclude, therefore, that the doctrine of "unclean hands" does not bar the trustee from opposing the State's claim on equitable grounds.

C. *Exhaustion of State Administrative Remedies.*

Finally, the State urges that by seeking the injunction against further administrative consideration of the Koenecke protest and not pursuing it administratively, the trustee has failed to exhaust available state remedies and should, therefore, be precluded from contesting the State's claim. Under Section 2 of the Bankruptcy

Act, the bankruptcy court has exclusive jurisdiction over the determination of all claims except tax claims which, prior to bankruptcy, have been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

It should be noted that the claim here was not so adjudicated prior to bankruptcy even assuming it to be a tax claim. Moreover, there is considerable doubt that the State's claim is a tax claim at all. In determining that the graduated discount formula was constitutional, the Illinois Supreme Court, in *Heyman* v. *Mahin*, 49 Ill. 2d 284, the case in which the trustee here sought to recover amounts paid under protest after the multiple licenses were cancelled, held that the discounts were not part of a tax but merely compensation paid to a cigarette distributor for its services for purchasing and affixing the tax stamps.

If the claim here involved is not one for taxes, several results follow. The limitations on the application of the doctrine of estoppel to a sovereign in revenue matters are inapplicable, the claim is entitled to no priority, and the bankruptcy court clearly had jurisdiction to allow or deny it. In any event, whether or not it is a tax claim, no exhaustion of state administrative remedies by the trustee is required.

CONCLUSION.

We conclude, based on all of the foregoing, that the referee's decision and order should be affirmed. An appropriate order will enter.

/s/ HUBERT L. WILL,
United States District Judge.

Dated: July 9, 1975.

IN THE UNITED STATES COURT OF APPEALS,
For the Seventh Circuit.

No. 75-1844
In the Matter of:

F. W. KOENECKE & SONS, INC., an Illinois Corporation,
Bankrupt,

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,
Claimant-Appellant,

vs.

GLENN R. HEYMAN,
Trustee-Appellee.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division—
No. 69 B 1647.
HUBERT L. WILL, *Judge.*

Argued February 10, 1976—Decided April 20, 1976.

Before FAIRCHILD, *Chief Circuit Judge*, TONE and BAUER, *Circuit Judges.*

BAUER, *Circuit Judge.* Involuntary bankruptcy proceedings were initiated against F. W. Koenecke & Sons, Inc. ("Koenecke") in 1969. Following an adjudication of bankruptcy a receiver/trustee was appointed and a priority tax claim was presented by the State of Illinois in the amount of $1,268,334.60 for unpaid taxes under the Illinois Cigarette Tax Act and Cigarett Use Tax Act for the period of July 1, 1965 to June 30, 1968. The bankruptcy judge disallowed the claim and the district court affirmed.

The central issue on appeal is whether the State of Illinois is estopped to recover the taxes because of the involvement of state employees in Koenecke's plan to obtain maximum tax discounts through multiple licenses. We reverse.

Prior to its bankruptcy Koenecke was the largest licensed cigarette distributor in Illinois. It was required by Illinois law to collect and remit the tax imposed on the sale and use of cigarettes. Ill. Rev. Stats. 1963, Ch. 20, §§ 453.1-453.67. A distributor prepays the cigarette tax by purchasing tax stamps and affixing them on the cigarettes to be sold. For its services in purchasing and affixing the stamps, Koenecke was entitled to receive a discount, which up until 1963 was a flat 5% of all stamps purchased.

By an Act approved July 16, 1963, Ill. Rev. Stats. 1963, Ch. 20, § 453.2(b), the Illinois General Assembly enacted a graduated declining discount schedule to reflect the high volume distributor's decreased cost per revenue stamp affixed. The constitutionality of the graduated discount was upheld by the Illinois Supreme Court in *Heyman* v. *Mahin*, 49 Ill. 2d 284, 275 N. E. 2d 421, *cert. denied* 405 U. S. 1075 (1972).

The maximum discount was fixed at 1⅔% of the first $700,000 of tax paid by a licensed distributor during the year, reduced to 1⅓% of the next $700,000, 1% of the next $700,000 and ⅔ of 1% of any additional taxes paid. The discount rate schedule was further revised in 1965 and 1967.

In the case of Koenecke, its volume of cigarettes sales was so high that the purchase of $700,000 in stamps occurred at the end of one week, and the minimum discount bracket was reached in the first three weeks of each year.

To circumvent the graduated declining discount formula of the statute and to insure the highest possible discount for its operations, Robert F. Koenecke, the principle shareholder of the bankrupt company, and his wife, filed over 52 multiple license applications as cigarette distributors in the individual names of company employees.

Theodore Issacs, then Director of the Illinois Department of Revenue, received a legal opinion from William J. Clark, then Attorney General for the State of Illinois, informing him that multiple licenses could not be issued to persons closely related to a distributor unless: "Separate applications are made by each licensee distributor which are in all other respects conformable to the statute. . . ." There is a serious dispute between the parties as to whether or not the Clark opinion sanctioned the multiple licensing scheme devised by Koenecke to obtain favorable tax treatment. Although the opinion is somewhat nebulous, we believe that the Attorney General's opinion made it clear that in order to obtain multiple licenses the persons applying must have been qualified distributors and not merely persons who purported to be distributors. Nevertheless, officials of the Illinois Department of Revenue having responsibility for administering the cigarette tax acts granted secondary or multiple licenses to persons closely related to Koenecke even though it was obvious that such secondary licensees were mere figureheads and were to be utilized solely for the purpose of avoiding the effect of the graduated discount law.

In fact employees of the state affirmatively participated in Koenecke's attempt to minimize taxes.[1] The evidence shows that one of the Department of Revenue's auditors actually taught Koenecke personnel how to compute and report the nominal intercompany transfers to and from secondary licensees which were shown on the monthly returns. It was admitted that from time to time Department personnel called Koenecke and other distributors to remind them that it was time to change licenses in order to avoid going over the $700,000 limit.

1. The record indicates that not all state employees were willing to cooperate with the Koenecke plan. Hildren L. Carney, Supervisor of Liquor & Cigarette Revenue Division, who was immediately responsible for processing and approving license applications, objected to the issuance of multiple licenses. However, he was ordered by his superior to "be a good soldier, or a good boy—and see that these licenses are issued" (Tr. 3/18/74, a.m., pp. 52, 59, 61, 87; Tr. 3/18/75 p.m., pp. 9, 19).

There is no doubt Koenecke's licensees were mere figureheads and never intended to or did, in fact, engage in the business as distributors of cigarettes. Many of the Koenecke employees, who were presented to the State of Illinois as licensees, denied signing or authorizing Koenecke to sign their signatures to the license applications. However two former key employees testified that it was common knowledge among all employees that their names were being used in order to obtain secondary licenses and thus qualify for maximum discounts. Koenecke testified that he had the express or implied authority of the person whose name he signed. The trial judge did not expressly find that Koenecke had authority but did find that the procedure was common knowledge among employees and that the secondary licenses were publicly displayed on a bulletin board in the common work room of the company.

In 1968, a new director, Theodore Jones, took action against the multiple license procedure used by Koenecke and other distributors. He ordered all of the so-called "secondary" licenses to be cancelled and directed his staff to make audits to assess the difference between the discounts received under the multiple licensing procedure and the correct discount available as a single licensed distributor.

Although the multiple license scheme originated with Koenecke, other smaller distributors in the state adopted the same practice. The state admits that they have not pursued collection of additional taxes from these distributors. Koenecke claims that such conduct is a violation of the constitutional right of equal protection and that it is a victim of the State's discriminatory tactics. However, the state contends that the evidence shows that only Koenecke consistently falsified license applications and that the record is barren of evidence that any other licensee was guilty of such flagrant conduct. In addition the state points out that Koenecke avoided over $2,000,000[2] in

2. No claim has been filed for additional unpaid taxes, estimated to be $800,000, for the two year period from July 16, 1967 to June 30, 1965, for which recovery is barred by statute (Ill. Rev. Stats. 1973, Ch. 102, § 444).

unpaid cigarette taxes while the average discrepancy for every other distributor was only $32,000. The State Department of Revenue's decision not to make assessments the other distributors does not rise to the level of a controlling administrative determination of state law, especially in view of the Illinois Supreme Court cases discussed below. It amounted only to an election by the state to proceed only against Koenecke. That election did not violate Koenecke's federal equal protection rights, because the trustee has not shown that it "was deliberately based upon an unjustifiable standard such as race, religion, or other arbitrary classification." *Oyler* v. *Boles*, 368 U. S. 448, 456 (1962).

The application of the doctrine of estoppel in cases involving tax collection and revenue matters is a difficult question of Illinois law. On the one hand there are some clear decisions which hold that the State is estopped from denying or repudiating actions or conduct in which it actively participated. *Pressed Steel Car Co.* v. *Lyons*, 7 Ill. 2d 95, 129 N. E. 2d 765 (1955); *People* v. *Thomas*, 361 Ill. 448 (1935); *Trustees* v. *Village of Cahokia*, 357 Ill. 538 (1934); *Melin* v. *Community Consolidated School District*, 312 Ill. 376 (1924). The doctrine of estoppel has also been applied against the State where necessary to prevent patent unfairness or injustice. *Hickey* v. *Illinois Central Railroad*, 35 Ill. 2d 427, 220 N. E. 2d 415 (1966); *New-Mark Builders, Inc.* v. *City of Aurora*, 90 Ill. App. 2d 98, 233 N. E. 2d 44 (1967); *City of Quincy* v. *Sturham*, 18 Ill. 2d 604, 165 N. E. 2d 271 (1960).

On the other hand there is clear precedent that the estoppel doctrine should not apply against the State in revenue matters. *Austin Liquor Mart Inc.* v. *Dept. of Revenue*, 15 Ill. 2d 1, 280 N. E. 2d 437 (1972); *Mr. Car Wash, Inc.* v. *Dept. of Revenue*, 27 Ill. App. 2d 931, 327 N. E. 2d 88 (1975); *People ex rel. Scott* v. *Chicago Thoroughbred Enterprises, Inc.*, 56 Ill. 2d 210, 306 N. E. 2d 7 (1974). The rationale of these cases is that people of the State should not be denied taxes rightfully owing because of mistakes or collusive fraud on the part of the state

employees. The Illinois Supreme Court expressed this principle in the *Austin Liquor Mart, supra,* case, where it stated:

> "Plaintiff contends that a 'final assessment' is equally binding on both parties and once the notice of tax liability becomes final and the assessment is paid, defendant is barred from further investigation. We do not agree. It is firmly established that where the public revenues are involved, public policy ordinarily forbids the application of estoppel to the State. *Department of Revenue* v. *Barding*, 33 Ill.2d 235; *Skillet Fork River Outlet Union Drainage Dist.* v. *Central Lumber Co.*, 31 Ill.2d 312; *People* v. *Chas. Levy Circulating Co.*, 17 Ill.2d 168; *Clare* v. *Bell*, 378 Ill. 127; *People* v. *Women's Athletic Club*, 360 Ill. 577; 1 A.L.R.2d 338."

In this case we think the facts are more closely analogous to the line of cases that hold that the state may not be estopped by the conduct of its employees in revenue matters. We are persuaded primarily by the *Chicago Thoroughbred Enterprises* decision (*supra*) which is strikingly similar to the issues and facts presented by Koenecke's multiple license plan to defeat the graduated discount formula for cigarette tax collections.

In *Chicago Thoroughbred Enterprises* the Illinois General Assembly also enacted a graduated horse racing privilege tax to replace a prior flat rate tax. Chicago Thoroughbred Enterprises was the largest horse racing licensee in the State, and was the only Illinois operator to fall within the maximum rate of the new graduated tax schedules.

Because of its size and volume of operations, Chicago Thoroughbred Enterprises was able to avoid taxes averaging $750,000 per year by dividing itself into two purported racing divisions and obtaining two separate licenses.

As with Koenecke, the State officials responsible for issuing licenses, and for daily calculating and collecting the taxes due, permitted the multiple license scheme to exist without protest until five years later. By the time an independent suit was filed by the Illinois Attorney General, the total amount of unpaid

horse racing privilege taxes had accumulated to $4,937,687.21 for the period 1966 through 1971.

The taxpayer first contested the constitutionality of the graduated tax and then argued that the State was estopped to retroactively recompute the tax due. As in the case at bar, the taxpayer argued that its corporate operations and the use of designated racing divisions were well known to State officials and were unchallenged throughout the period in dispute. The taxpayer pointed out that the State actually provided its own inspectors at the track who had verified the tax figures and accepted the tax payment for each racing day without objections.

Similar to Koenecke's argument that it passed on its tax savings to the consumers, the taxpayer in the *Chicago Thoroughbred Enterprises* case argued that it never even received 44% of its monies in dispute which were immediately distributed as purses to the horsemen participating in the daily races. And further, the taxpayer noted, the corporate ownership had been subsequently purchased by the present management in reliance upon public and company books and records and balance sheets showing no outstanding tax liability.

Despite these truly extraordinary circumstances and despite the active participation and approval of State officials in every phase of the multiple licensing scheme, and despite the equitable arguments advanced by the taxpayer, the Illinois Supreme Court said, in reversing the trial court: "That State inspectors performed the ministerial acts of computing the tax due under one particular formula does not estop the State from repudiating that formula", and entered judgment against Chicago Thoroughbred Enterprises for $4,947,687.21 and in a companion case ordered the release to the State of an additional $642,968 from a protest fund established for 1972 taxes.

Although appellee Koenecke's argument in favor of estoppel has some tone of sympathy in light of the facts of this case, we nevertheless feel compelled to follow the decision of the Illinois Supreme Court in *Chicago Thoroughbred Enterprises.*

The facts of the *Chicago Thoroughbred Enterprises* case are directly on point and the Court leaves no doubt as to its ruling, stating:

> ". . . Our decisions, however, have made it clear that the doctrine of estoppel cannot be invoked where governmental activities of the State are concerned, particularly those relating to the public revenues, except in extraordinary circumstances" (306 N. E. 2d at 12).

We do not perceive this case as being one of extraordinary circumstances in which gross injustice or inequity results. Certainly the equities were even more on the side of the taxpayer in *Chicago Thoroughbred Enterprises* than in the present case. Yet, the Court held that those facts did not present extraordinary circumstances. Thus the State of Illinois is not estopped from presenting its tax claim in this bankruptcy proceeding and it was error for the claim to be barred.

On appeal, the trustee has also raised several collateral points which we believe deserve comment. First, the argument is made that the State's claim was properly subordinated to the claims of the general creditors. We agree that under basic equitable principles any portion of claims to participate on a parity with or subordinate to the claims of general creditors. *Pepper* v. *Litton*, 308 U. S. 295, 304-5, 84 L. Ed. 281, 60 S. Ct. 238 (1939); Collier on Bankruptcy, Vol. 3, ¶ 57.14, pp. 211-212. But in this instance we think the bankruptcy judge's conclusion of law No. 16 was wrong in holding that it would be inequitable for the State to participate on a priority or even equal basis with the other creditors. We believe that the proper view of the facts does not show that the state is profiting at the expense of the creditors. Rather all the people of the State are benefited when taxes which are lawfully owing are collected. Therefore we are of the opinion that the bankruptcy judge should not have subordinated the State's claims of general creditors unless the general creditors can establish some type of priority for their claims under the bankruptcy act. However considering the history of this case and the conduct of the State, any claims

for interest or costs of collection would be inequitable and properly disallowed by the bankruptcy court. The creditors of Koenecke, of course, are not being penalized or prosecuted in any way. Their complaints are against Koenecke not the State. Their right to enjoy the illegal fruit of the Koenecke scheme by usurping the unpaid State taxes resulting from the multiple license plan can be no greater than the taxpayer's right to avoid those taxes.

The trustee has also raised the question of whether the State's claim here is merely for a return of compensation as opposed to a claim for taxes. He points out that if the claim is for compensation and not taxes it can only rank as a general unsecured claim. In our view there is no doubt that the claim presented is for taxes. Although the discount allowed by the State is intended to compensate tthe distributor for the costs of affixing the stamps, *Heyman* v. *Mahin, supra,* indicates that the distributor must pay the taxes based on sales after subtracting his discount. The money wrongfully withheld by Koenecke is that amount over and above the allowable discount for compensation of costs of affixing the stamps, i.e., money owed to the State for each tax stamp that was placed on each package of cigarettes distributed.

Finally, the trustee points out that the State's charges of fraud and corruption are not supported in the record, and that the charge of collusion was raised for the first time on appeal. We agree that with the trustees that the State had ample oppportunity to develop such evidence, and, having failed to do so, is not now in a position to advance such an argument. Nevertheless, in reaching our decision we have relied primarily on the Illinois Supreme Court's decision in *Chicago Thoroughbred Enterprises* and not on the State's allegation of fraud and collusion.

Accordingly, the judgment of the district court is reversed and the case is remanded for further proceedings not inconsistent with this opinion.

REVERSED.

UNITED STATES COURT OF APPEALS,
For the Seventh Circuit,
Chicago, Illinois 60604.

June 2, 1976.

Before

HON. THOMAS E. FAIRCHILD, *Chief Judge*
HON. PHILIP W. TONE, *Circuit Judge*
HON. WILLIAM J. BAUER, *Circuit Judge*

In the Matter of: F. W. KOENECKE & SONS, INC., an Illinois corporation, *Bankrupt.* No. 75-1844 Appeal of: DEPARTMENT OF REVENUE, STATE OF ILLINOIS, *Claimant.*	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division. (69 B 1647)

On consideration of the petition of the Trustee-Appellee, Glenn R. Heyman for rehearing and suggestion that it be reheard *in banc* filed in the above-entitled cause, no judge in active service having requested a vote thereon, nor any judge having voted to grant the suggestion, and all of the members of the panel having voted to deny a rehearing,

IT IS ORDERED that the petition of the Trustee-Appellee, Glenn R. Heyman for a rehearing in the above-entitled cause be, and the same is hereby, DENIED.

U. S. CONSTITUTION.

AMENDMENT XIV.

Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

BANKRUPTCY ACT.

SECTION TWO (11 U. S. C. § 11).

§ 2. Creation of Courts of Bankruptcy and Their Jurisdiction. a. The courts of the United States . . . are hereby invested . . . with such jurisdiction at law and in equity as will enable them to . . . (2A) Hear and determine, or cause to be heard and determined, any question arising as to the amount or legality of any unpaid tax, whether or not previously assessed, which has not prior to bankruptcy been contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction, . . .

BANKRUPTCY ACT.

SECTION SEVENTEEN (11 U. S. C. § 35).

§ 17. Debts Not Affected by a Discharge. a. A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof

within three years preceding bankruptcy: *Provided, however,* That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this Act: *And provided further,* That a discharge in bankruptcy shall not release or affect any tax lien; (2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsover with intent to deceive, or for willful and malicious conversion of the property of another; (3) have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor had notice or actual knowledge of the proceedings in bankruptcy; (4) were created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity; (5) are for wages and commissions to the extent they are entitled to priority under subdivision a of section 64 of this Act; (6) are due for

moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of a contract of employment; (7) are for alimony due or to become due, or for maintenance or support of wife or child, or for seduction of an unmarried female, or for breach of promise of marriage accompanied by seduction, or for criminal conversation; or (8) are liabilities for willful and malicious injuries to the person or property of another other than conversion as excepted under clause (2) of this subdivision.

BANKRUPTCY ACT.

SECTION SIXTY (11 U. S. C. § 96).

§ 60. Preferred Creditors. a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

(2) For the purposes of subdivisions a and b of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a

petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of the petition.

(3) The provisions of paragraph (2) shall apply whether or not there are or were creditors who might have obtained such liens upon the property other than real property transferred and whether or not there are or were persons who might have become bona fide purchasers of such real property.

(4) A lien obtainable by legal or equitable proceedings upon a simple contract within the meaning of paragraph (2) is a lien arising in ordinary course of such proceedings upon the entry or docketing of a judgment or decree, or upon attachment, garnishment, execution, or like process, whether before, upon, or after judgment or decree and whether before or upon levy. It does not include liens which under applicable law are given a special priority over other liens which are prior in time.

(5) A lien obtainable by legal or equitable proceedings could become superior to the rights of a transferee or a purchase could create rights superior to the rights of a transferee within the meaning of paragraph (2), if such consequences would follow only from the lien or purchase itself, or from such lien or purchase followed by any step wholly within the control of the respective lien holder or purchaser, with or without the aid of ministerial action by public officials. Such a lien could not, however, become so superior and such a purchase could not create such superior rights for the purposes of paragraph (2) through any acts subsequent to the obtaining of such a lien or subsequent to such a purchase which require the agreement or concurrence of any third party or which require any further judicial action, or ruling.

(6) The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section. If a transfer is for security if (A) applicable law requires a signed and delivered writing, or a delivery of possession, or a filing or re-

cording, or other like overt action as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: *Provided, however,* That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: *And provided further,* That nothing in paragraph (6) shall be construed to be contrary to the provisions of paragraph (7).

(7) Any provision in this subdivision a to the contrary notwithstanding if the applicable law requires a transfer of property other than real property for or on account of a new and contemporaneous consideration to be perfected by recording, delivery, or otherwise, in order that no lien described in paragraph (2) could become superior to the rights of the transferee therein, or if the applicable law requires a transfer of real property for such a consideration to be so perfected in order that no bona fide purchase from the debtor could rceate rights in such property superior to the rights of the transferee, the time of transfer shall be determined by the following rules:

I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than twenty-

one days, and compliance therewith is had within twenty-one days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

II. Where compliance with the law applicable to the transfer is not had in accordance with the provisions of subparagraph I, the transfer shall be deemed to be made or suffered at the time of compliance therewith, and if such compliance is not had prior to the filing of the petition initiating a proceeding under this Act, such transfer shall be deemed to have been made or suffered immediately before the filing of such petition.

(8) If no such requirement of applicable law specified in paragraph (7) exists, a transfer wholly or in part, for or on account of a new and contemporaneous consideration shall, to the extent of such consideration and interest thereon and the other obligations of the transferor connected therewith, be deemed to be made or suffered at the time of the transfer. A transfer to secure a future loan, if such loan is actually made, or a transfer which becomes security for a future loan, shall have the same effect as a transfer for or on account of a new and contemporaneous consideration.

b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security is voidable, the court may

on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

c. If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him.

d. If a debtor shall, directly or indirectly, in contemplation of the filing of a petition by or against him, pay money or transfer property to an attorney at law, for services rendered or to be rendered, the transaction may be examined by the court on its own motion or shall be examined by the court on petition of the trustee or any creditor and shall be held valid only to the extent of a reasonable amount to be determined by the court, and the excess may be recovered by the trustee for the benefit of the estate.

If, whether before or after filing, a debtor shall agree orally or in writing to pay money or transfer property to an attorney at law after the filing, the transaction may be examined by the court on its own motion or shall be examined by the court on petition of the bankrupt made prior to discharge and shall be held valid only to the extent of a reasonable amount to be determined by the court, and any excess obligation shall be cancelled, or if excess payment or transfer has been made, returned to the bankrupt.

e. (1) Where the bankrupt is a stockbroker, the following definitions and provisions of this subdivision shall apply: "Property" shall include cash, securities, whether or not negotiable,

and all other property of similar character; "customers" of a stockbroker shall include persons who have claims on account of securities received, acquired, or held by the stockbroker from or for the account of such persons (a) for safekeeping, or (b) with a view to sale, or (c) to cover consummated sales, or (d) pursuant to purchases, or (e) as collateral security, or (f) by way of loans of securities by such persons to the stockbroker, and shall include persons who have claims against the stockbroker arising out of sales or conversions of such securities; "cash customers" shall mean customers entitled to immediate possession of such securities without the payment of any sum to the stockbroker; the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities; the "net equity" of a customer's account shall be determined by excluding any specifically identifiable securities reclaimable by the customer and by subtracting the indebtedness of the customer to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockbroker liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer.

(2) All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy: *Provided, however,* That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2) subdivision a of section 64 of this Act. If such fund shall not be sufficient

to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors.

(3) Any property remaining after the liquidation of a pledge made by a stockbroker shall be apportioned between his general estate and such single and separate fund in the proportion in which the general property of the stockbroker and the property of his customers contributed to such pledge.

(4) No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.

(5) Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockholder of any property which, except for such transfer, woud have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this Act. For the purpose of such recovery the property so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. If any securities received or acquired by a stockbroker from a cash customer are transferred by the stock-

broker, such customer shall not have any specific interest in or specific right to any securities of like kind on hand at the time of bankruptcy, but such securities of like kind or the proceeds thereof shall become part of such single and separate fund: *Provided, however,* That a customer shall have a specific title to securities (a) which have been physically set aside by a stockbroker, more than four months before his bankruptcy or while solvent, in safekeeping for such customer, and so retained until the date of bankruptcy, regardless of the name in which such securities are registered, or (b) which a stockbroker, more than four months before his bankruptcy or while solvent, caused to be registered in the name of such customer.

BANKRUPTCY ACT

SECTION SIXTY-FOUR (11 U. S. C. § 104)

§ 64. Debts Which Have Priority. a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be. . . .

(4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and . . .

BANKRUPTCY ACT

SECTION SIXTY-SEVEN (11 U. S. C. § 107)

§ 67. Liens and Fraudulent Transfers.

d. (1) for the purposes of, and exclusively applicable to, this subdivision d: (a) "Property" of a debtor shall include only his nonexempt property: (b) "debt" is any legal liability, whether matured or unmatured, liquidated or unliquidated, absolute, fixed, or contingent; (c) "creditor" is a person in whose favor a debt exists; (d) a person is "insolvent" when the present fair salable value of his property is less than the amount required to pay his debts; and to determine whether a partnership is insolvent, there shall be added to the partnership property the present fair salable value of the separate property of each general partner in excess of the amount required to pay his separate debts, and also the amount realizable on any unpaid subscription to the partnership of each limited partner; and (e) consideration given for the property or obligation of a debtor is "fair" (1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied, or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared with the value of the property or obligation obtained.

(2) Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent; or (b) as to then existing creditors and as to other persons who become creditors during the continuance of a business or transaction, if made or incurred without fair consideration by a debtor who is engaged or is

about to engage in such business or transaction, for which the property remaining in his hands is an unreasonably small capital, without regard to his actual intent; or (c) as to then existing and future creditors, if made or incurred without fair consideration by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature; or (d) as to then existing and future creditors, if made or incurred with actual intent as distinguished from intent presumed in law, to hinder, delay, or defraud either existing or future creditors.

(3) Every transfer made and every obligation incurred by a debtor who is or will thereby be rendered insolvent, within four months prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent, as to then existing and future creditors: (a) if made or incurred in contemplation of the filing of a petition initiating a proceeding under this Act by or against the debtor or in contemplation of liquidation of all or the greater portion of the debtor's property, with intent to use the consideration obtained for such transfer or obligation to enable any creditor of such debtor to obtain a greater percentage of his debt than some other creditor of the same class, and (b) if the transferee or obligee of such transfer or obligation, at the time of such transfer or obligation, knew or believed that the debtor intended to make such use of such consideration. The remedies of the trustee for the avoidance of such transfer or obligation and of any ensuing preference shall be cumulative: *Provided, however,* That the trustee shall be entitled to only one satisfaction with respect thereto.

(4) Every transfer of partnership property and every partnership obligation incurred within one year prior to the filing of a petition initiating a proceeding under this Act by or against the partnership, when the partnership is insolvent or will be thereby rendered insolvent, is fraudulent as to partner-

ship creditors existing at the time of such transfer or obligation, without regard to actual intent if made or incurred (a) to a partner, whether with or without a promise by him to pay partnership debts, or (b) to a person not a partner without fair consideration to the partnership as distinguished from consideration to the individual partners.

(5) For the purposes of this subdivision d, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, but, if such transfer is not so perfected prior to the filing of the petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of such petition.

(6) A transfer made or an obligation incurred by a debtor adjudged a bankrupt under this Act, which is fraudulent under this subdivision d against creditors of such debtor having claims provable under this Act, shall be null and void against the trustee, except as to a bona fide purchaser, lienor, or obligee for a present fair equivalent value: *Provided, however,* That the court may, on due notice, order such transfer or obligation to be preserved for the benefit of the estate and, in such event, the trustee shall succeed to and may enforce the rights of such transferee or obligee: *And provided further,* That such purchaser, lienor, or obligee, who without actual fradulent intent has given a consideration less than fair, as defined in this subdivision d, for such transfer, lien, or obligation, may retain the property, lien, or obligation as security for repayment.

(7) Nothing contained in this subdivision d shall be construed to validate a transfer which is voidable under section 60 of this Act.

BANKRUPTCY ACT

SECTION SEVENTY (11 U. S. C. § 110)

§ 70. Title to Property. c. The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a particular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy or a different transaction. . . .

§ 70 e. (1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this Act which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this Act, shall be null and void as against the trustee of such debtor.

(2) All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such transfer or obligation shall be avoided by, the trustee for the benefit of the estate: *Provided, however,* That the court may on due notice order such transfer or obligation to be preserved for the benefit of the estate and in such event the trustee shall succeed to and may enforce the rights of such transferee or obligee. The trustee shall reclaim and recover such property or collect its value from and avoid such transfer or obligation against whoever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision a is valid under applicable Federal or State laws.

(3) For the purpose of such recovery or of the avoidance of such transfer or obligation, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

ILLINOIS CONSTITUTION OF 1870.

ARTICLE IX REVENUE

§ 1. Tax by valuation, how levied

The general assembly shall provide such revenue as may be needful by levying a tax, by valuation, so that every person and corporation shall pay a tax in proportion to the value of his, her or its property—such value to be ascertained by some person or persons, to be elected or appointed in such manner as the general assembly shall direct, and not otherwise; but the general assembly shall have power to tax peddlers, auctioneers, brokers, hawkers, merchants, commission merchants, showmen, jugglers, innkeepers, grocery keepers, liquor dealers, toll bridges, ferries, insurance, telegraph and express interests or business,

vendors of patents, and persons or corporations owing or using franchises and privileges, in such manner as it shall from time to time direct by general law, uniform as to the class upon which it operates.

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ILLINOIS REVISED STATUTES

CHAPTER 120—REVENUE

453.9a Examination and correction of returns—Fraud—Protest—Hearing—Penalty.] § 9a. (1) As soon as practicable after any return is filed, the Department shall examine such return and shall correct such return according to its best judgment and information, which return so corrected by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein. Instead of requiring the distributor to file an amended return, the Department may simply notify the distributor of the correction or corrections it has made. Proof of such correction by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. Such reproduced copy shall, without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein. If the Department finds that any amount of tax is due from the distributor, the Department shall issue the distributor a notice of tax liability for the amount of tax claimed by the Department to be due, together with a penalty of 10% thereof, but if the incorrectness of any return as determined by the Department is due to fraud, such penalty shall be 25% of the tax due. If, in administering the provisions of this Act, comparison of a return or returns of a distributor with the books, records and inventories of such distributor dis-

closes a deficiency which cannot be allocated by the Department to a particular month or months, the Department shall issue the distributor a notice of tax liability for the amount of tax claimed by the Department to be due for a given period, but without any obligation upon the Department to allocate such deficiency to any particular month or months, together with a penalty of 10% thereof, under which circumstances the aforesaid notice of tax liability shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein; and proof of such correctness may be made in accordance with, and the admissibility of a reproduced copy of such notice of tax liability shall be governed by, all the provisions of this Act applicable to corrected returns. If the deficiency so determined by the Department is due to fraud, the penalty shall be 25% of the tax due. If any distributor filing any return dies or becomes incompetent at any time before the Department issues its notice of tax liability, such notice shall be issued to the administrator, executor or other legal representative, as such, of such distributor.

(2) If, within 20 days after such notice of tax liability, the distributor or his legal representative files a protest to such notice of tax liability and requests a hearing thereon, the Department shall give notice to such distributor or legal representative of the time and place fixed for such hearing, and shall hold a hearing in conformity with the provisions of this Act, and pursuant thereto shall issue a final assessment to such distributor or legal representative for the amount found to be due as a result of such hearing. If a protest to the notice of tax liability and a request for a hearing thereon is not filed within 20 days after such notice of tax liability, such notice of tax liability shall become final without the necessity of a final assessment being issued and shall be deemed to be a final assessment.

(3) In case of failure to pay the tax, or any portion thereof, or any penalty provided for in this Act, when due, the Department may bring suit to recover the amount of such tax, or portion thereof, or penalty; or, if the taxpayer dies or becomes incompetent, by filing claim therefor against his estate; provided that no such suit with respect to any tax, or portion thereof, or penalty, shall be instituted more than 2 years after the cause of action accrues, except with the consent of the person from whom such tax or penalty is due.

After the expiration of the period within which the person assessed may file a suit for judicial review under the Administrative Review Act without such a suit being filed, a certified copy of the final assessment or revised final assessment of the Department may be filed with the Circuit Court of the county in which the taxpayer has his principal place of business, or of Sangamon County in those cases in which the taxpayer does not have his principal place of business in this State. The certified copy of the final assessment or revised final assessment shall be accompanied by a certification which recites facts that are sufficient to show that the Department complied with the jurisdictional requirements of the Act in arriving at its final assessment or its revised final assessment and that the taxpayer had his opportunity for an administrative hearing and for judicial review, whether he availed himself of either or both of these opportunities or not. If the court is satisfied that the Department complied with the jurisdictional requirements of the Act in arriving at its final assessment or its revised final assessment and that the taxpayer had his opportunity for an administrative hearing and for judicial review, whether he availed himself of either or both of these opportunities or not, the court shall render judgment in favor of the Department and against the taxpayer for the amount shown to be due by the final assessment or the revised final assessment, and such judgment shall be entered in the judgment docket of the court. Such judgment shall bear the same rate of interest and shall have the same effect as other judgments. Execution shall issue upon such judgment upon the request of the Department, and all laws applicable

to sales on execution shall be applicable to sales made under such judgments. The Department shall file the certified copy of its assessment, as herein provided, with the Circuit Court within 2 years after such assessment becomes final except when the taxpayer consents in writing to an extension of such filing period.

If, when the cause of action for a proceeding in court accrues against a person, he is out of the State, the action may be commenced within the times herein limited, after his coming into or return to the State; and if, after the cause of action accrues, he departs from and remains out of the State, the time of his absence is no part of the time limited for the commencement of the action; but the foregoing provisions concerning absence from the State shall not apply to any case in which, at the time the cause of action accrues, the party against whom the cause of action accrues is not a resident of this State. The time within which a court action is to be commenced by the Department hereunder shall not run while the taxpayer is a debtor in any proceeding under the Federal Bankruptcy Act nor thereafter until 90 days after the Department is notified by such debtor of being discharged in bankruptcy.

No claim shall be filed against the estate of any deceased or incompetent person for any tax or penalty or part of either except in the manner prescribed and within the time limited by the Probate Act of this State.

The remedies provided for herein shall not be exclusive, but all remedies available to creditors for the collection of debts shall be available for the collection of any tax or penalty due hereunder.

The collection of tax or penalty by any means provided for herein shall not be a bar to any prosecution under this Act.

The certificate of the Director of the Department to the effect that a tax or amount required to be paid by this Act has not been paid, that a return has not been filed, or that information has not been supplied pursuant to the provisions of this Act, shall be prima facie evidence thereof.

All of the provisions of Sections 5a, 5b, 5c, 5d, 5e, 5f, 5g, 5h, 5i and 5j of the "Retailers' Occupation Tax Act" in effect on the effective date of this amendatory Act, as subsequently amended, which are not inconsistent with this Act, shall apply, as far as practicable, to the subject matter of this Act to the same extent as if such provisions were included herein. References in such incorporated Sections of the "Retailers' Occupation Tax Act" to retailers, to sellers or to persons engaged in the business of selling tangible personal property shall mean distributors when used in this Act.

Amended by P. A. 76-721, § 1, eff. Aug. 8, 1969.

ILLINOIS REVISED STATUTES

CHAPTER 120—REVENUE

453.43a Failure to file return—Determination of tax by department—Evidence—Hearing—Protest.] § 13a. In case any person who is required to file a return under this Act fails to file such return, the Department shall determine the amount of tax due from him according to its best judgment and information, which amount so fixed by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown in such determination. Proof of such determination by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. Such reproduced copy shall, without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein. The Department shall issue such person a notice of tax

liability for the amount of tax claimed by the Department to be due, together with a penalty of 25% thereof. If such person or the legal representative of such person, within 20 days after such notice, files a protest to such notice of tax liability and requests a hearing thereon, the Department shall give notice to such person or the legal representative of such person of the time and place fixed for such hearing, and shall hold a hearing in conformity with the provisions of this Act, and pursuant thereto shall issue a final assessment to such person or to the legal representative of such person for the amount found to be due as a result of such hearing. If a protest to the notice of tax liability and a request for a hearing thereon is not filed within 20 days after such notice of tax liability, such notice of tax liability shall become final without the necessity of a final assessment being issued and shall be deemed to be a final assessment. As amended by act approved Sept. 7, 1967. L. 1967, p. 4029.

Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-288

GLENN R. HEYMAN, Trustee of the Estate of F. W. KOENECKE & SONS, INC., Bankrupt,
Trustee, Petitioner,

vs.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,
Claimant, Respondent.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,
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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

QUESTIONS PRESENTED

1. Whether the People of the State of Illinois are estopped to recover unpaid taxes because of the corruption, misconduct or negligence of State employees;

2. Whether the perpetrator and beneficiary of a fraudulent scheme to escape lawful taxes may assert the temporary success of that scheme to defeat the People's claim for payment of correct taxes once the scheme has been exposed;

3. Whether the general creditors of a bankrupt taxpayer may defeat the priority of a State tax claim and enjoy the proceeds of a fraudulent tax evasion scheme perpetrated by the bankrupt and delinquent public officials.

STATEMENT OF THE CASE

On March 13, 1969, involuntary bankruptcy proceedings were initiated against F. W. Koenecke & Sons, Inc., then the largest cigarette distributor in Illinois. After Koenecke was adjudicated bankrupt on April 1, 1969, Glenn R. Heyman, Petitioner, was appointed as receiver and trustee for the bankrupt estate.

On April 8, 1969, the Illinois Department of Revenue filed a priority tax claim for $1,268,334.60. This sum represented only a portion of the Illinois Cigarette tax and cigarette use tax which Koenecke defrauded Illinois taxpayers. An additional $800,000 recovery was banned by Illinois statutes.

The Petitioner filed objections which were sustained by the District Court but reversed by a unanimous decision of the United States Court of Appeals. 533 F.2d 1020. From the denial of his petition from rehearing on June 2, 1976, the present action was commenced.

STATEMENT OF FACTS

On April 20, 1976, Messrs. Justices Fairchild, Tone and Bauer rendered their Opinion in the cause at bar. (533 F 2d 1020). It found that:

> The central issue on appeal is whether the State of Illinois is estopped to recover the taxes because of the involvement of state employees in Koenecke's plan to obtain maximum tax discounts through multiple licenses. We reverse. (533 F 2d at 1021)

The Court then held that Illinois taxpayers were *not* estopped to recover due to the illicit participation of state employees in Koenecke's fraud. In reaching this decision, the Seventh Circuit determined that:

> 1) In Illinois a distributor prepays the cigarette tax by purchasing tax stamps and affixing them on the cigarettes to be sold. For its services in purchasing and affixing the stamps, Koenecke was entitled to receive a discount, which up until 1963 was a flat 5% of all stamps purchased. (id., at 1021)
>
> 2) In 1963, . . . the Illinois General Assembly enacted a graduated declining discount schedule to reflect the high volume distributor's decreased cost per revenue stamp affixed. (id., at 1021)
>
> 3) In the case of Koenecke, its volume of cigarettes sales was so high that the purchase of $700,000 in stamps occurred at the end of one week, and the minimum discount bracket was reached in the first three weeks of each year. (id., at 1021)
>
> 4) To circumvent the graduated declining discount formula of the statute and to insure the highest possible discount for its operations, Robert F. Koenecke, the principal shareholder of the bankrupt company, and his wife, filed over 52 multiple license applications as cigarette distributors in the individual names of company employees. (id., at 1021)

5) There is no doubt Koenecke's licensees were mere figureheads and never intended to or did, in fact, engage in the business as distributors of cigarettes. Many of the Koenecke employees, who were presented to the State of Illinois as licensees, denied signing or authorizing Koenecke to sign their signatures to the license applications. (id., at 1022)

6) In our view there is no doubt that the claim presented is for taxes. Although the discount allowed by the State is intended to compensate the distributor for the costs of affixing the stamps, *Heyman v. Mahin, supra,* indicates that the distributor must pay the taxes based on sales after subtracting his discount. The money wrongfully withheld by Koenecke is that amount over and above the allowable discount for compensation of costs of affixing the stamps, i. e., money owed to the State for each tax stamp that was placed on each package of cigarettes distributed. (id., at 1025)

7) In fact employees of the state affirmatively participated in Koenecke's attempt to minimize taxes.[1] The evidence shows that one of the Department of Revenue's auditors actually taught Koenecke personnel how to compute and report the nominal intercompany transfers to and from secondary licensees which were shown on the monthly returns. It was admitted that from time to time Department personnel called Koenecke and other distributors to remind them that it was time to change licenses in order to avoid going over the $700,000 limit.

[1] The record indicates that not all state employees were willing to cooperate with the Koenecke plan. Hildren L. Carney, Supervisor of Liquor & Cigarette Revenue Division, who was immediately responsible for processing and approving license applications, objected to the issuance of multiple licenses. However, he was ordered by his superior to "be a good soldier, or a good boy—and see that these licenses are issued" (Tr. 3/18/74 a.m., pp. 52, 59, 61, 87; Tr. 3/18/74 p.m., pp. 9, 19). (id., at 1022)

8) Other distributors followed Koenecke's multiple license scheme. However, the state contends that the evidence shows that only Koenecke consistently falsified license applications and that the record is barren of evidence that any other licensee was guilty of such flagrant conduct. In addition the state points out that Koenecke avoided over $2,000,000 in unpaid cigarette taxes while the average discrepancy for every other distributor was only $32,000. (id., at 1022)

9) Moreover . . . there is clear precedent that the estoppel doctrine should not apply against the State in revenue matters. *Austin Liquor Mart Inc. v. Dept. of Revenue,* 51 Ill.2d 1, 280 N.E.2d 437 (1972); *Mr. Car Wash, Inc. v. Dept. of Revenue,* 27 Ill.App.3d 931, 327 N.E.2d 88 (1975); *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.,* 56 Ill.2d 210, 306 N.E.2d 7 (1974). The rationale of these cases is that people of the State should not be denied taxes rightfully owing because of mistakes or collusive fraud on the part of the state employees. (id., at 1023)

10) The creditors of Koenecke, of course, are not being penalized or prosecuted in any way. Their complaints are against Koenecke not the State. Their right to enjoy the illegal fruit of the Koenecke scheme by usurping the unpaid State taxes resulting from the multiple license plan can be no greater than the taxpayer's right to avoid those taxes. (id., at 1025)

Having made these determinations, the United States Court of Appeals held that:

> . . . in this instance we think the bankruptcy judge's conclusion of law #16 was wrong in holding that it would be inequitable for the State to participate on a priority or even equal basis with the other creditors. We believe that the proper view of the facts does not show that the state is profiting

at the expense of the creditors. Rather all the people of the State are benefited when taxes which are lawfully owing are collected. Therefore we are of the opinion that the bankruptcy judge should not have subordinated the State's claim to the claims of general creditors unless the general creditors can establish some type of priority for their claims under the bankruptcy act. (id., at 1024-1025)

From this decision, the present proceedings were commenced.

ARGUMENT

I.

THE COURT OF APPEALS PROPERLY HELD THAT THE PEOPLE ARE NOT ESTOPPED TO RECOVER LAWFUL TAXES WRONGFULLY EVADED BY A FRAUDULENT MULTIPLE LICENSING SCHEME.

In its decision, the court of Appeals held that:

> . . . there is clear precedent that the estoppel doctrine should not apply against the State in revenue matters. *Austin Liquor Mart Inc. v. Dept. of Revenue*, 51 Ill.2d 1, 280 N.E.2d 437 (1972); *Mr. Car Wash, Inc. v. Dept. of Revenue*, 27 Ill.App.3d 931, 327 N.E.2d 88 (1975); *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.*, 56 Ill.2d 210, 306 N.E.2d 7 (1974). The rationale of these cases is that people of the State should not be denied taxes rightfully owing because of mistakes or collusive fraud on the part of the state employees. (533 F 2d at 1023)

The inapplicability of estoppel doctrine in revenue matters was exhaustively researched in *Austin Liquor Mart, Inc. v. Dept. of Revenue*, 51 Ill. 2d 1, 4-5, 280 N.E. 2d 437, 439 (1972):

> "Plaintiff contends that a 'final assessment' is equally binding on both parties and once the notice of tax liability becomes final and the assessment is paid, defendant is barred from further investigation. We do not agree. It is firmly established that where the public revenues are involved, public policy ordinarily forbids the application of estoppel to the State. *Department of Revenue v. Barding*, 33 Ill. 2d 235; *Skillet Fork River Outlet Union Drainage Dist. v. Central Lumber Co.*, 31 Ill. 2d 312; *People v. Chas. Levy Circulating Co.*, 17 Ill. 2d 168; *Clare v. Bell*, 378 Ill. 128; *People v. Women's*

Athletic Club, 360 Ill. 577; 1 A.L.R. 2d 338.) 'It seems to be universally recognized that, generally, a State cannot be estopped by the acts and conduct of its officers or agents in the performance of the governmental function of collecting taxes legally due. * * * *United States v. Globe Indemnity Co.*, 94 F. 2d 576 (C.A. 2), [cert. den. 304 U.S. 575, 58 S. Ct. 1047] *Olson Constr. Co. v. State Tax Com.*, 12 Utah 2d 42, 361 P. 2d 1112; *Henderson v. Gill*, 229 N.C. 313, 49 S.E. 2d 754; *Michigan Sportservice, Inc. v. Nims*, 319 Mich. 561, 30 N.W. 2d 281; *Claiborne Sales Co. v. Collector of Revenue*, 233 La. 1061, 99 So. 2d 345, *Commonwealth v. Western Md. R.R. Co.*, 377 Pa. 312, 105 A. 2d 336; 31 C.J.S., Estoppel, sec. 138; 19 Am. Jur., Estoppel, Sec. 166; Bigelow, Estoppel (6th Ed.), p. 372; 1 Cooley Taxation, p. 159. Cf. *Gontrum v. Mayor & City Council of Baltimore*, 182 Md. 370, 35 A. 2d 128." (*Comptroller of Treasury v. Atlas General Industries*, 234 Md. 77, 198 A. 2d 86, 90.) 'The government is not estopped by previous acts or conduct of its agents with reference to the determination of tax liabilities or by failure to collect the tax, nor will the mistakes or misinformation of its officers estop it from collecting the tax. *State Tax Commission v. Johnson*, 75 Idaho, 105, 269 P. 2d 1080; *Fitzpatrick v. State Tax Commission*, 15 Utah 2d 29, 386 P. 2d 896; *Tennessee Trailways, Inc. v. Butler*, 215 Tenn. 136, 373 S.W. 2d 201; *Good Will Industries of Southern Calif. v. Los Angeles Co.*, 117 Cal. 2d 19, 254 P. 2d 877; *Claiborne Sales Co. v. Collector of Revenue*, 233 La. 1061, 99 So. 2d 345; *Duhame v. State Tax Commission*, 65 Ariz. 268, 179 P. 2d 252.' *State v. Adams*, 90 Idaho 195, 409 P. 2d 415, 419; 31 C.J.S., Estoppel, sec. 147."

See also *Mr. Car Wash, Inc. v. Department of Revenue*, 27 Ill. App. 3rd 931, 327 N.E. 2d 88, 90-91 (1975) where the court most recently held:

> "Although the record indicates that the Chicago office of the Department made a mistake in allowing the deduction, this does not estop the Department from collecting revenues rightfully belonging to the State merely because plaintiff relied on the prior audit in continuing to take the .05 deduction."

As the court explained in *Comptroller of Treasury v. Atlas General Industries*, 234 Md. 77, 198 A. 2d 86, 90 (1964):

> "The reason for the rule is obvious: no administrative officer is vested with the power to abrogate the statute law of the State, nor to grant to an individual an exemption from the general operation of the law."

See also *United States v. Davenport*, 297 F. 2d 284, 285 (CA 4, 1961).

Article IX, Section 6 of the 1870 Illinois Constitution, in effect at the time of the Koenecke tax fraud, provides:

> "The general assembly shall have no power to release or discharge any county, city, township, town or district whatever, or the inhabitants thereof, or the property therein, from their or its proportionate share of taxes to be levied for state purposes, nor shall commutations for such tax be authorized in any form whatsoever."

The Illinois Supreme Court has consistently ruled that if the General Assembly cannot release or commute tax liability, neither can an executive or administrative officer do so. *Massell v. Daley*, 404 Ill. 479, 484, 89 N.E. 2d 361 (1950); *People ex rel. Ames v. Marx*, 370 Ill. 264, 269, 18 N.E. 2d 915 (1939).

This principle has been preserved in Article IX, Section 1 of the 1970 Illinois Constitution.

In *Utah Power & Light Co. v. United States*, 243 U.S. 389, 409, 37 S. Ct. 387, 61 L. Ed. 791 (1916), the United States Supreme Court considered and explicitly rejected the petitioner's rationalizations.

> As presenting another ground of estoppel it is said that the agents in the forestry service and other officers and employees of the Government, with knowledge of what the defendants were doing, not only did not object thereto but impliedly acquiesced therein until after the works were completed and put in operation. This ground also must fail. As a general rule laches or neglect of duty on the part of officers of the Government is no defense to a suit by it to enforce a public right or protect a public interest.

It does not take great imagination to calculate the incentive for corruption if taxpayers could escape tax liability in the millions of dollars by the fortuitous collaboration of government agents in the collection of a tax.

The Court of Appeals stated that:

> We are persuaded primarily by the Chicago Thoroughbred Enterprises decision [56 Ill 2d 210, 306 NE 2d 7 (1974)] . . . which is strikingly similar to the issues and facts presented by Koenecke's multiple license plan to defeat the graduated formula for cigarette tax collections. (id., 533 F 2d at 1023)

The *Chicago Thoroughbred Enterprises* case had its inception in the same Kerner-Isaacs administration which spawned the Koenecke fraud. [See *United States v. Kerner & Isaacs*, 351 F. Supp. 1323; 364 F. Supp. 895; 493 F. 2d 1124, 417 U.S. 976; 418 U.S. 955]

Two years after the General Assembly enacted the graduated discount formula for cigarette tax collections, it similarly adopted a graduated horse racing privilege tax to replace a prior flat rate tax. [Ill. Rev. Stats. 1965, Chap. 8, § 37J1] As with Koenecke, C.T.E. was the largest horse racing licensee in the State, and was the only Illinois operator to fall within the maximum rate of the new graduated tax schedule.

Because of its size and volume of operations, by dividing itself into two purported racing divisions and obtaining two separate licenses, C.T.E. was able to avoid taxes averaging $750,000 per year.

As with Koenecke, the State officials responsible for issuing licenses, and for daily calculating and collecting the taxes due, permitted the multiple license scheme to exist without protest until it was publicly exposed five years later. By the time an independent suit was filed by the Illinois Attorney General, the total amount of unpaid horse racing privilege taxes had accumulated to $4,937,-687.21 for the period 1966 through 1971.

As in the case at bar, the taxpayer first contested the constitutionality of the graduated tax, and then argued that the State was estopped to retroactively recompute the tax due.

As in the case at bar, the taxpayer argued that its corporate operations and the use of designated racing divisions were well known to State officials and were unchallenged throughout the period in dispute.

As in the case at bar, the taxpayer argued that the State actually provided its own inspectors at the track who had verified the tax figures and accepted the tax payment for each racing day without objection.

As in the case at bar, the taxpayer argued that it never even received 44% of the monies in dispute which were immediately distributed as purses to the horsemen participating in the daily races, and, further, that the corporate ownership had been subsequently purchased by the present management in reliance upon public and company books and records and balance sheets showing no outstanding tax liability.

Despite the truly extraordinary circumstances of the C.T.E. case, and despite the active participation and approval of State officials in every phase of the multiple licensing scheme, and despite the compelling equitable arguments advanced by the taxpayer, and contrary to the lower court herein, the Illinois Supreme Court said: "That State inspectors performed the ministerial acts of computing the tax due under one particular formula does not estop the State from repudiating that formula." and entered judgment in favor of the People of the State for $4,937,687.21 and in a companion case ordered the release to the State of an additional $642,968 from a protest fund established for 1972 taxes.

It should be especially noted in the case at bar, that notwithstanding the highly suspicious facts adduced in evidence, neither the Trustee-Appellee nor the court explored the possible improper motivation for Revenue Director Isaacs and Assistant Director Hulman to aid and abet the Koenecke scheme as they did. The State of Illinois most certainly had no public purpose in acting to administratively repeal the new graduated discount statute and releasing over $2,000,000 of tax revenue for the benefit of Koenecke.

The trustee-appellee made no showing that the wrongful acts of Isaacs and Hulman were a legitimate exercise of administrative discretion, and the Bankruptcy Judge and District Court found otherwise.

Thus, it is respectfully submitted that this is clearly a case of breach of public trust where the vital interests of the People of the State must be aggressively protected by the courts and not undermined by misdirected efforts to invoke inappropriate principles of estoppel.

II.

THE COURT OF APPEALS RIGHTLY HELD THAT THE PERPETRATOR AND BENEFICIARIES OF A FRAUDULENT TAX EVASION SCHEME ACQUIRE NO EQUITABLE RIGHT TO ENJOY THE PROCEEDS OF A FRAUD.

In the trustee's Petition for Certiorari, it is argued at page 16 that ". . . the only true distinction between Koenecke's case and all the others [cigarette distributors] is in the dollar amounts involved." It is respectfully submitted that this conclusion is

> drawn from pure speculation as to facts de hors the record. There was no evidence introduced that other cigarette distributors initiated the scheme and forged signatures on 36 license applications, as Koenecke did, or that any other distributor engaged in a scheme of the magnitude and pervasiveness as the one devised by Koenecke. (Tr. 10/14/69 P.M., p. 56) or did any more than avail themselves of a good thing.

Moreover,

> there is no merit or support in the record for the unsupported suggestion that Koenecke hadn't really profited from the more than $2,000,000 taken from the State, because he merely passed the tax savings along in the form of lower cigarette prices.
>
> In the first place, the actual testimony of Koenecke, without quantification, was that he had in fact pocketed part of the tax fraud proceeds. (Tr. 3/21/74 A.M. p. 5) Further, the court may take judicial notice that it is established business practice to balance lower product markups against the concomitant increase in sales volume, i.e. charge less, sell more and maximize profit.

Thus, the Court of Appeals stated:

> No claim has been filed for additional unpaid taxes, estimated to be $800,000, for the two year period from July 16, 1967 to June 30, 1965, for which

recovery is barred by statute (Ill.Rev.Stats. 1973, Ch. 120, § 444). (id., p. 1022)

Consequently, Koenecke has enjoyed use of the aforesaid $2,000,000 during a period when prime interest rates were reaching historic high levels, and the value of the money was actually additionally enhanced by the tight money market conditions.

In *People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.*, 56 Ill. 2d 210, 220-221, 306 N.E. 2d 7, 13, the court said:

". . . we must reject C.T.E.'s argument that a substantial portion of the track commission which remained after taxes . . . was paid over to the owners of the horses running in the meet, and that there is . . . no method by which the excess received by the owners may be recovered by C.T.E. While this would be of importance in a typical claim of estoppel, it cannot be considered when the doctrine of estoppel is inapplicable, as it is here."

Thus, the creditors of a temporarily successful wrongdoer cannot acquire any "equitable" right to rely on the wrongdoer's continued and undisturbed enjoyment of the proceeds of his fraud. It is the Illinois taxpayers who must be entitled to equity as the true victims of Koenecke's fraud.

The trustee has also suggested that the Respondents claim is not for taxes (Petition, pp. 21-22). This assertation is similarly without merit. The monies not lawfully withheld as an allowable discount are, without doubt, cigarette taxes. The distributor's obligation to pay the cigarette tax cannot be avoided. See e.g. *In Re Martin*, 75 F. 2d 618, 620 (CA 7, 1935); *In Re Mid America Co.*, 31 F. Supp. 601, 604 (S.D. Ill. N.D. 1939); *In Re Wm. Ashers, Jr., Co.*, 121 F. 2d 846, 850 (CA 3, 1941); *In Re Otto F. Lange Co.*, 159 F. 586, 588 (N.D. Iowa E.D. 1908).

In *In Re Jim Clay Tobacco Co., Inc.*, 335 F. Supp. 274, 276-277, 280 (N.D. Ga. 1973), involving a state claim in bankruptcy to recover unpaid Georgia cigarette taxes, the Court said:

"The conjunction of state and federal law make the conclusion mandatory that the Georgia Cigar and Cigarette Tax is levied against the distributor as a tax. Under the clear wording of the state act, as interpreted by the Georgia Court of Appeals, there is no *doubt that the distributor's liability is absolute, without regard to whether or not he is able to pass on the economic burden to his retail distributors and the ultimate retail consumers.* If the cigarettes are destroyed in a fire before the ultimate retail sale, while in the hands of a retail distributor, or if the retail distributor becomes a bankrupt, the distributor's obligation is nevertheless fixed. *Inability to collect from his vendees clearly does not absolve the distributor of the burden to pay* . . . (Emphasis added)

And the court further quotes with favor from *Blackman v. Coastal Service, Inc.*, 125 Ga. App. 28, 186 S.E. 2d 441 (1971):

"It being clear from the Georgia Cigar and Cigarette Tax Act, taken as a whole, that the liability of the distributor is fixed and absolute the moment he comes into the possession of cigarettes for the first time, the Court has no alternative but to find the obligation of the Bankrupt to the State . . . to be that of a tax liability. As a tax liability, the State would be entitled to a fourth priority claim under Section 64(a)4 of the Bankruptcy Act, and the objection of the Trustee to the claim is denied."

Given these decisions, the Court of Appeals was unquestionably correct in its rejection of the Petitioner's assertions.

III.

IT IS CONTRARY TO SOUND PUBLIC POLICY TO PERMIT WRONGDOERS TO ENJOY THE FRUITS OF THEIR FRAUD.

The greatest deterrent to tax fraud adventures is the certain knowledge that administrations will change and that no mistake or misunderstanding, no collusion or bribery can guarantee permanent success of the scheme and operate to defeat the People's right to collect lawful taxes once the fraud has been uncovered.

The fraudulent tax evasion scheme in the case at bar was able to exist with the imprimatur of the then Revenue Director, Theodore Isaacs, whose period of stewardship in public office was an unmitigated disaster.

In addition to his indictment and conviction for conspiracy, bribery and perjury [493 F. 2d 1124 (CA 7, 1974)], Isaacs had also been indicted for conflict of interests in negotiating contracts between the State and a private printing company in which he held financial interest. Although the indictment was quashed and dismissed, (*People v. Isaacs*, 37 Ill. 2d 205, 226 N.E. 2d 38 1967)) as a consequence, two justices of the Illinois Supreme Court were required to resign (In the Matter of the Special Commission in Relation to No. 39797) and the original trial judge was eventually suspended from the practice of law (Sup. Ct. No. 45998). Isaacs was also involved in the proceedings surrounding the multi-million dollar failure of the City Savings and Loan Association [*Tcherepnin v. Franz*, 64 C 1285, 277 F. Supp. 472, 371 F. 2d 374, 389 U.S. 332].

Consequently, "if there ever was or could be a case where the circumstances are so extraordinary as to justify the court to take action to defeat injustice" this is

indeed the case. However, as the Court of Appeals recognized, the Petitioner has grievously erred in his perception of the victim.

CONCLUSION

Wherefore, it is respectfully submitted that the Petition for Certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976.

No. 76-288

GLENN R. HEYMAN, TRUSTEE OF THE ESTATE OF F. W. KOENECKE & SONS, INC., BANKRUPT,

Petitioner,

vs.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,

Claimant, Respondent.

REPLY BRIEF IN SUPPORT OF CERTIORARI.

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I.

THE ALLEGED "FRAUD AND CORRUPTION" ATTRIBUTED TO THE BANKRUPT CORPORATION FURNISHES NO EXCUSE FOR THE DISCRIMINATION PRACTICED AGAINST THIS ESTATE.

In its brief the State of Illinois insists that the alleged fraudulent conduct of the bankrupt corporation furnished valid grounds for distinguishing the treatment afforded the Koenecke Estate from that afforded to all similarly situated taxpayers. In this connection three points should be noted.

First, the litigant in this case is not the bankrupt corporation but rather a trustee in bankruptcy acting on behalf of bona fide unsecured creditors. Under no conceivable theory can the trustee or creditors be charged with, or held responsible for, any of the alleged improprieties attributed to the bankrupt corporation.

Second, the Court of Appeals itself specifically declared that the State's charges of fraud and corruption were unsupported by the record and formed no basis for its decision.[1] At 533 F. 2d 1025 (A50) the Court of Appeals stated:

> "Finally, the trustee points out that the State's charges of fraud and corruption are not supported in the record, and that the charge of collusion was raised for the first time on appeal. *We agree with the trustees* (sic) *that the State had ample opportunity to develop such evidence, and, having failed to do so, is not now in a position to advance such an argument.*" (Emphasis Added.)

Finally, it must be recalled that the State itself conceded (Fdg. 80-81, A20) that the information regarding the alleged fraud was obtained after the original retroactive assessments were made against Koenecke and all the other distributors, and played no part in the decision to make the assessments. The fact that the State conducted such a vigorous after-the-fact investigation of Koenecke while making no attempt whatsoever to investigate the possibility of impropriety on the part of others who followed the identical practices (Fdg. 79, A20), is conclusive evidence of precisely the type of discrimination which the law prohibits.

This whole charge of fraud and corruption is nothing but a red herring designed to obscure the discriminatory treatment given to creditors of this estate. This technique is graphically illustrated by the State's discussion of its leading case, *People ex rel. Scott* v. *Chicago Thoroughbred Enterprises*, 56 Ill. 2d 210, 306 N. E. 2d 7 (1973). At page 10 of its brief the State declares:

> "The *Chicago Thoroughbred Enterprises* case had its inception in the same Kerner-Isaacs administration which *spawned the Koenecke fraud.*" (Emphasis partially supplied.)

1. The Court will note that the indented paragraphs at p. 13 of the State's brief are merely the State's own argument and not quotations from any court decision or other recognized authority.

The State then cites *United States* v. *Kerner and Isaacs*, 351 F. Supp. 1323, 364 F. Supp. 895; 493 F. 2d 1124, 417 U. S. 976, 418 U. S. 955, a criminal case which has no relationship whatsoever to either the facts or the legal issues of the present case.

Finally, after this blatant attempt at guilt by association, the State deliberately distorts the facts of this case by saying (Brief p. 10):

> "As with Koenecke, C. T. E. was the largest horse racing licensee in the State, and *was the only Illinois operator to fall within the maximum rate of the new graduated schedule.* (Emphasis added.)

The whole point of this appeal is that *unlike* C. T. E., Koenecke was by no means the only Illinois operator to fall within the maximum rate. The record is clear and undisputed that almost 30 other distributors fell into the same category and were nevertheless held by the State to be entitled to retain the benefits of the multiple licenses which they procured and employed in precisely the same manner as did Koenecke. (Fdg. 26, A10)

II.

THE STATE HAS FAILED TO REFUTE THE MAIN ARGUMENTS ADVANCED IN SUPPORT OF OUR PETITION.

Perhaps the most significant feature of the State's brief is not what it contains but what it omits. Nowhere does the State even attempt to meet the principal arguments advanced in support of the Petition for Certiorari. The questions of equitable subordination, equal protection of the laws, the rights of creditors in bankruptcy proceedings, and the overriding supremacy of federal law in bankruptcy cases are all completely ignored.

The State's silence on each of these critical issues is a tacit concession that the decision of the Court of Appeals did in fact constitute a departure from established principles of federal

constitutional and bankruptcy law as declared by this Court and other Courts of Appeals. This in itself warrants review on certiorari.

CONCLUSION.

WHEREFORE, the Trustee prays that the Petition for Certiorari be granted.

Respectfully submitted,

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